SECOND CONCURRENT RESOLUTION ON THE BUDGET—FISCAL YEAR 1982

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 15, 1981—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

SEPTEMBER 16, 1981
- VIEWS OF THE CHAIRMAN OF THE FEDERAL RESERVE BOARD
- VIEWS OF OUTSIDE ECONOMISTS

SEPTEMBER 28, 1981—EFFECT OF THE PRESIDENT'S ECONOMIC PROGRAM ON THE FINANCIAL MARKETS

OCTOBER 6, 1981
OCTOBER 15, 1981
OCTOBER 20, 1981
OCTOBER 30, 1981
VIEWS OF THE REAGAN ADMINISTRATION

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VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

TUESDAY, SEPTEMBER 15, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 11 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Quayle, Gorton, Hollings, Chiles, Biden, Johnston, Sasser, Hart, Metzenbaum, Riegle, Moynihan, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

Chairman DOMENICI. The meeting will come to order.

I want to say to the Senators who are here that I apologize for being late. I was detained talking with the Republican leadership with the President this morning. I apologize.

OPENING STATEMENT OF CHAIRMAN DOMENICI

I have some prepared remarks. They are very brief. First I want to welcome you, Dr. Rivlin. The views of the Congressional Budget Office on the economy and the Federal budget are important to us. We are delighted that you are here.

I am particularly pleased to have you here because, while your deficit projections in the outyears are higher than I would like to see, the economic assessment that you have for 1982, 1983, and 1984 are, in my opinion, very close to those that we have accepted in our resolution. They indicate in terms of the economy a quite upbeat approach from the standpoint of your office and those economists that advise you.

INFLATION

It seems to me that at no time in the past 4 years have we had or are we permitted to have more confidence that inflation is coming down. I think your projections indicate that in a significant way. In the first 6 months of the year we had 5 months with single-digit inflation. That is rather healthy and different than some of the forecast realities of the past. Whether or not it was possible to be projecting 8 percent inflation when we did, that was seriously questioned, but obviously that is occurring. You have something to say about that today.

INTEREST RATES

The interest rates, obviously, are very difficult. It is almost impossible for many business people in America, small and large, to finance anything. Homebuilding is having a difficult time as well as homebuyers and appliance sellers. It is having a very significant impact both on the confidence and on the activities.

SPENDING CUTS

I believe that the most constructive role for the committee in developing the second resolution should be to reduce spending in 1982 wherever possible and reasonable and to begin the task of fleshing out the specifics of the budget cuts that will be required to reduce the deficit and move in the direction of a balanced budget for 1984. I think we need to pursue steadfastly the budget plan we set out last spring. If Congress as a whole does that, I believe the credit markets will respond.

In this regard, I note in your testimony that you touch on the issue of spending cuts, particularly the parts of the budget in which substantial reductions have already been made. I certainly would hope that we would go into that in more detail. I hope you will identify this morning other parts of the budget that have been relatively spared and to which we might look for additional cuts.

DEFENSE EXPENDITURES

The possibility of slowing the growth in defense expenditures is receiving a lot of attention. I hope and believe Congress will take a good look at that.

ENTITLEMENTS

Frankly, the reconciliation bill which has now become law dealt fairly lightly with entitlement programs across the board, cutting them only an average of 4.5 percent, or should I say reducing their growth by only 4.5 percent, while domestic nonentitlement programs have been cut on an average of 16 percent. That is my understanding of the numbers. The net result is that, if we do nothing more to the underlying laws, entitlement costs will continue to grow rapidly between 1981 and 1984. As an example, between 1981 and 1984 social security will grow by almost 12 percent, medicare by 16 percent, in excess of 16 percent, and Federal civilian retirement almost 11 percent.

Entitlements will make up almost 57 percent of the budget in 1984. It is at least the chairman's view that they must bear a proportionate share of further cutting.

So, I am anxious to hear you, Dr. Rivlin, and to have your assistance as we move through the next 3 or 4 weeks.

Now I would yield to the distinguished ranking minority member, Senator Hollings.

OPENING STATEMENT OF SENATOR HOLLINGS

Senator HOLLINGS. Thank you, Mr. Chairman. I will propose during the course of this debate more realistic economic assumptions. We have been through the economic assumption debate before and I do not know that I will prevail. I do not intend to make a Federal case, but I still intend to make a point not just for the record but for the sobriety of my colleagues and the Congress itself.

I believe the CBO figures and estimates in the first concurrent resolution were more nearly on target. I find now, Dr. Rivlin, your estimates optimistic, too optimistic in the sense that inflation is not likely to slow to the pace you have projected. The recent good price performance is due to price breaks on energy and food commodities. This is temporary.

The productivity growth rate would have to increase sizably in order to realize the growth rate predicted, 3 percent. That is just not in the cards. It was not in the cards in Dr. Rivlin's March projections. It is not in the cards here in September.

But I think there is an even more serious problem for this particular Budget Committee rather than to focus upon which economic forecast is correct because we all can be right, we all can be wrong. We have been through it, and no one is going to get angry over whatever the committee adopts. I think, on the other hand, that we have got to take stock and realize that this committee now has opportunity, but not one to find further spending cuts.

LOSS OF REVENUES KEEPS GOVERNMENT IN RED

The ox is in the ditch, Mr. Chairman and distinguished colleagues. We are in deep trouble. Reagan came, he has seen, and he has conquered. Word was that when we went home in August Reagan had conquered the Congress, but now the realization is he has not conquered the economy. When you lose $93 billion in revenues in 1983, $150 billion in revenues in 1984, $199 billion in 1985, and $286 billion in 1986, you have guaranteed Government in the red all the way into President Reagan's second term, if such there be. And that is exactly what the financial market is looking at. You can see the morning headline of poor Secretary Regan out imploring them to have faith and have confidence, either on the one hand take time or, on the other hand, let's show a little bit better support for the President's program. This is a sophomoric exercise compared to the genuine concern that everyone has expressed on Wall Street.

The fact of the matter is that I was rather alarmed last week at the reaction of the administration and the leadership. I guess during the Navy days we used to say: When in danger, when in doubt, run in circles, scream and shout. And there they were. You had them asking for the Nixon leadership program and standing in the rain asking for the Nixon impoundment program.

Most respectfully, Mr. Chairman, now you are asking for the McGovern defense cut of $30 billion. I never heard $30 billion recommended around this place except by George McGovern back in 1972.

You got the majority leader saying the financial market is like a drug addict on heroin, they're hooked like on drugs. And you have the minority whip saying, after we passed a tax bill that rewarded savings, let's penalize them and tax interest rates.

You are getting all kind of wild reactions. They are all momentary. They are fragmented, and they show a total lack of understanding and appreciation of the true dilemma.

You can cut $15 billion from the program, and that is 10 percent of what you will be able to get at because of the simple fact that, if you got $100 billion in interest, you got $200 billion in defense, is $300 billion. You got $150 billion in social security. That is $450 billion. And you can make up another $100 billion. And medicare is $40 billion. And unemployment compensation is $20 billion, and the veterans is $25 billion, and $15 billion for the civil service retirees. That only leaves you, in the $700 billion budget, about $150 billion to play with. And 10 percent of that, $15 billion, is not the problem when you are losing $199 and $268 billion in those outyears.

Thirty billion dollars, Senator Domenici, from defense is not going to make it. Reconciling Stockman and Weinberger is not going to make it. And announcing it soon, so that Wall Street could react to it by Monday morning is not going to make it. They reacted. You saw that reaction.

That shows a total lack of awareness and understanding for the real dilemma. Until we do that, we are not going to get the program back on track or get this country out of the economic doldrums.

OPPORTUNITY FOR REAL RECONCILIATION

I think this Budget Committee has a wonderful opportunity for real reconciliation. Reconciliation was never intended to start off the fiscal year with a state of the Union message and then reconcile it. On the contrary, we were supposed to pass tax cuts, spending cuts, appropriation bills, and then in this second concurrent resolution reconcile the final judgment. If we do our jobs, we can save this whole situation.

I looked at last week's programs and initiatives. The biggest flaw, of course, was the matter of trying to cut more from regular programs. Silvio Conte, the Republican senior Member over on the House side, said they are already bloody. He cannot carry his troops back in the ditches again. It is pure naivete to say: Dr. Rivlin, please identify the parts of the budget that have been spared; that is nonsense. Dr. Rivlin gave out a booklet of 150 places to go last year, and that is what Dave Stockman grabbed up and acted like it was his idea after he pooh-poohed the entire budget process, the Budget Committees and CBO. Then he took up the work that he had been ridiculing and debunking for several years in the Congress. He acted like it was a great discovery.

Everything has been touched that realistically and politically can be cut. You might find $2 or $3 billion but we are looking in terms of $60 to $80 billion now to assure some kind of balanced budget by fiscal year 1984. But, you are not saying where we will save. That is not going to move the business community and the stockholders. The amusing thing is all of our good Republican colleagues are good stockholders. They know what it is. They know what they have lost. You lost 83 points since April since you started this first concurrent resolution and program. You lost $47 billion in 2 days last week out of that market.

So, you have got to go about it in a comprehensive way. You have got to go about it in this second concurrent resolution and have true reconciliation. And there have got to be some sacrifices.

ENTITLEMENTS

Let me propose this. We started last week talking about entitlements. You well know on the COLA issue I made a recommendation back in February with respect to indexing by the lesser of either the wage or price index. We were unsuccessful on that one. We cannot get the support for it.

On entitlements last week I notice the distinguished chairman on "Face the Nation" say perhaps 3 percent. I suggested that in a talk last week that, we could take away 3 percent of the COLA growth temporarily for the next 3 years. Whereas this year they received, for example, 11.2 percent, they would get instead an 8.2-percent increase. That would guarantee every recipient his check. That would guarantee everyone an increase, and they as part of a package would make their sacrifice.

Unfortunately, there are too many votes of record, 96 to nothing, against such changes. We voted on social security about seven times. As the President admonished us yesterday talking about AWACS, don't get fixed in concrete. I am afraid, Senator Domenici, they have gotten fixed in concrete on that one.

IMPOUND TAX CUT

So, to be realistic, I now suggest revenue changes that I think would be appealing in the context of the tremendous fiscal fiasco that we are now in. Rather than impounding spending cuts we ought to impound the tax cut. If you could get a vote to impound that personal tax cut or put in a trigger that would be a step forward. If you can persuade anybody to do anything on that tax cut, that ought to be done forthrightly. Go ahead now and have the 5-percent tax cut this year but limit 1983 and 1984 cuts rather than 10 percent to 5 percent each year. Then, if you meet your goals of budget balance, you have got a Congress which loves to give tax cuts. They are ready. They are willing. They are able. And all politicians like tax cuts particularly before the election year 1984. So, we do not even have to promise that. The financial market and the people of America know exactly what will happen.

So, what we really ought to do in order to reconcile this budget, we should impound 5 percent of that tax cut. That is the individual income tax cut.

Let me caution this is a package here. We should impound just the individual across-the-board tax cut, not business. Business is a very small minimal part when you talk about the loss of $100 to $150 billion $199 billion and $268 billion. The loss in business, the cuts are only $10 billion next year, $18 billion the following year, and $28 billion in 1984. So, there is no real revenue gain there. And you can carry through with the fundamentals of President Reagan's program having a 3-year period for their depreciation allowance and investment tax credit. The trouble with American industry today is the lack of productivity. Business must plan ahead. We do want to revive and reindustrialize, and rejuvenate the economy.

We can do it leaving the Reagan program intact on business but saying on the personal side, the demand side of it, that we limit that to 5 percent. In that way you can pick up $25 billion in 1983 and $40 billion in 1984.

INDEXING

One of the things that does not impact on the balanced budget in 1984 is the indexing provision, but it is very costly in later years. That was just an afterthought, never thoroughly debated. You folks had the bit in your teeth. You all were racing pellmell down the road. You tasted blood and you were ready to gobble up the flock. You could not even talk sense to anybody.

I reiterate, I constantly almost nag the point: yes, Government makes $70 billion this year from inflation; but, since our entitlement programs are indexed, we lose $83.1 billion. So, we are $13 billion in the hole just trying to keep programs levelly funded. The Government does not make money out of inflation. That's a hard one for them to understand over there. It's a hard one for them to understand about tax cuts. We have had seven tax cuts in the last 10 years, and the President said at the beginning of the year we were not going to have more of the same. And that's exactly what we got, guns and butter. We had it under Johnson and now we have got it with tax cuts and increased defense costs. So, we are trying to get guns and butter on the same act, the same program, only, while we lost $731 billion in the 10-year period prior to the Reagan administration, Reagan guarantees we will lose $750 billion in tax revenues over 5 years. He just expedites it.

OIL INDUSTRY TAX BREAKS

Now let's go to the ones that are politically realistic: Oil industry tax breaks and repeal deduction for intangible drilling costs.

The oil industry tax breaks were a sham and a discredit to this body. I had to debate these tax cuts with my Republican colleagues from the State of South Carolina who voted for it. They immediately always went into work and food stamps and everything: We got to put them back to work, you know. The food stamp program is only about $11.2 billion, I think, right now. If you really wanted to save $11 or $20 billion, you gave that much to the oil companies. You were not worried about $11.2 billion. I told them categorically they just did not like poor people; that was their trouble. But when we are talking about $11 or $20 billion, this is what you gave to the oil companies.

We gave awards to royalty owners, stripper wells, and the independents--and they talk about the independent operators. They are $2 and $3 billion a year companies. You ought to look at that list of independents, small, little independents. One day I was over at the International Paper Co. My State is in timber. I had just finished a debate with Russell Long, whose State is in oil. He was talking about going after the timber companies and I was telling him about our difficulties. You know, everybody argues his own constituency. So, after I thought I had made a pretty good argument I went over to the International Paper reception to get the good Government award, I went over there and said I would save the timber interest. They said, "Well, we've been having hard times but things are looking up; we want you to meet our new attorney." I went over and met the new attorney. He said, "Yes; we're going to turn things around; we just made a purchase of General Crude." I said, "A purchase of General Crude?"

He said, "Yes, we bought that for $490 million, a little mom and pop operation." These independents, Senator Johnston, little, small mom-and-pop operations.

Senator JOHNSTON. They are going broke.

Senator HOLLINGS. Going broke. You got my Du Pont. I got four Du Pont facilities. They run around trying to buy up oil companies. You got the liquor companies trying to buy up oil companies. Everybody is trying to buy up oil companies. And here comes the Congress in the greatest debauchery I have ever seen dealing out money to the oil companies and then coming back and telling the Director of the CBO to find more spending cuts. That is terrible conduct, in my opinion.

We have got to take hold of ourselves here, repeal those oil industry tax breaks, the intangible drilling costs. They started back in 1954, when the oil industry asked for controls. That is what they told Eisenhower, that they could not compete with $2-a-barrel oil. It just did not make sense economically. They had to have a quota and controls on the quota and the extra dollars. That came about because oil asked for controls.

So, this was the incentive. They do not need the incentive with decontrol; they got plenty.

NATURAL GAS DECONTROL

Windfall profit tax on natural gas—I mentioned sacrifice. I emphasize here the package nature. The package nature is what is going to sell this. For example, I would start filibustering this afternoon, perhaps, with Senator Metzenbaum and others against the outright decontrol of natural gas.

When I came to the Congress as a freshman, Senator Magnuson sent me up for the brownouts and blackouts of 1965 and 1966 with the Federal Power Commission. I was a freshman and nobody even cared about the issue at the time. But I had a witness back in 1974 or 1975, James Carter from Gulf Oil. He was the vice president. All the gas we were consuming at that time had been produced at 26 cents. The Government, through political maneuver, had gotten the price up to 32 cents. The argument before the Congress was 60 cents. I got tired of the argument whether the price should be 45, 60, or 65 cents. So, I just said: Mr. Carter, what about $1; how about $1 an M ft^3 for natural gas? He said, "Senator, that would bring in all the gas we got in this country, all offshore, onshore and anywhere you could find it." He said, "That would be all the incentives we would need and more."

I will show you that in the record. They ushered him out and he never has been back to Washington. Now this crowd is talking about $4 and $5 an M ft^3. And I will ask Dr. Rivlin here—and I am sure we can confirm it. But, if you are going to propose the decontrol of natural gas anyway at some point then as a part of a package, we should at least get a windfall profit tax on gas. You can pick up $15 billion immediately this next fiscal year.

CONSUMER DEBT INTEREST DEDUCTION

Repeal the consumer debt interest deduction, which we should not be promoting at this particular time, trying to get interest rates down. You can see the total revenue changes across the board there. You can accept the President's defense budget.

I know the chairman is anxious to move along to the witness, and so am I; but I think this is even important. The particular economic projections, we will decide on those. But, we need to come as a Budget Committee in a bipartisan way with a package here in this second concurrent resolution to raise revenues and reduce the deficit. I am going to introduce Jack Kemp as a Democratic mole; he's ruined you. We are going to give him a testimonial dinner.

In any event——

Chairman DOMENICI. Why don't you let us do that?

Senator HOLLINGS. All right.

We will reduce the interest costs across the board. You can see the total reduction in the deficit for 1982 would be $33.3 billion; 1983, $63.3 billion; and $81.3 billion in 1984. Under the CBO's economic assumptions you would actually start—I wish I had Steve Symms here. He and some others on that side wanted to get a balanced budget in 1983. There is no law against that. But under the CBO's assumptions we immediately get a balanced budget, but we would still have under my assumptions, which I think are more realistic a $17 billion deficit. You would get your $42 billion deficit in 1982, but in 1983 it would be $17 billion deficit. And you would have definitely the balanced budget in 1984.

I think that the emphasis should be on the package itself. It all has to work together. Yes, you would like to go to entitlements. Yes, you would like to get further spending cuts. Yes, you can talk about further defense cuts, but you are going to destroy the defense part of the Reagan program, I can tell you that. And it would be below, Senator, what you and I even voted for 2 years ago, when you and I thought we ought to have 5 percent real growth.

So, you can go up all those little paths individually, and we can argue and beat each other up; but we have to develop a package. It has to be immediate. You cannot wait for October for the 5-percent tax cut to begin or next year's April tax day or the following year's 10 percent. The market has to have a clear, comprehensive, and convincing signal that they can rely upon. They do not need the political talks and persuasions and rah-rah conduct that we have been having here. We have to go about this in a serious fashion. I think it is a wonderful opportunity.

I would ask unanimous consent that my prepared statement and this chart along with the economic assumptions be inserted in the record at this particular time, and I thank you all for your indulgence.

Chairman DOMENICI. The statement will be made a part of the record. I assume that includes details of your suggestion.

[The prepared statement follows:]

PREPARED STATEMENT OF SENATOR HOLLINGS

Mr. Chairman, fellow committee members, this spring, the Reagan Administration told the country how to get itself out of its serious economic difficulties. The President asked Congress to enact massive spending cuts and to pass a large tax cut. He promised that this combination would restore the country's economic vitality and bring us to the promised land of a balanced budget by fiscal year 1984, Congress complied by doing just what the President asked. We gave him the largest budget cuts in history. We gave him the Reagan-Kemp-Roth tax cut. The President left town in a blaze of glory at the end of July, and Congress basked in the reflection. Supposedly, the corner had been turned and the economic atmosphere had been completely changed. All would be well, we were assured by the apostles of the new wisdom. The unity of theory and practice had finally been achieved in the theology of supply-side economics—the faith of George Gilder made tangible by the good works of David Stockman.

HIGHER DEFICITS PREDICTED

Not all of us, of course, were taken in by the new economic rhetoric. And now, our fears are proving to be true. Just one short month after passing all of the Administration's economic program, those promises of a corner-turned and an economy invigorated ring hollow. The stock market has dropped out. The prime interest rate remains above 20 percent. Ninety-day Treasury bills draw over 15 percent interest. And we end the fiscal year with the discouraging news that instead of budget deficits shrinking, the prognosis is for far more red ink than the Administration had ever planned on. Instead of the $42.5 billion deficit predicted by the Administration as late as just a few weeks ago, we are now looking squarely in the face of a 1982 deficit of as much as $65 billion. It gets worse, not better, in the out-years—as much as $70 billion in 1983 and $80 billion and more in 1984. No wonder Wall Street is not convinced. No wonder the market has dropped 100 points since August. The bottom line of the national budget is not improving. All the trauma of cutting programs we have been through in recent months, all the lobbying and cajoling have yielded no improvement in the bottom-line figures. By irresponsibly diminishing Government revenues, and by promising guns and butter both via increased defense expenditures and decreased taxes, the Reagan Administration is inevitably headed toward 4 more years of busted budgets and high inflation. Dress it up in the fancy new title of supply-side economics, present it as a revelation from on-high, paint it how you want—it's the same old tired economic practice that has been tried and found wanting for a decade and more. "The old business as usual treatment can't save us," President Reagan told the Nation on February 5. And then he prescribed, you guessed it—business as usual. For a Congress that had cut income taxes in 1964, again in 1969, again in 1971, twice in 1975, again in 1976, again in 1977 and again in 1978, there was no novelty in the Reagan proposal for yet another reduction in tax revenues.

Fundamental flaws inhered in the Reagan Administration approach to budgeting and taxes.

SPENDING CUTS ALONE WILL NOT BALANCE BUDGET

Flaw number one was the idea that by spending cuts alone we could achieve a balanced budget. I applaud the President for his diligence in helping the Congress cut $35 billion in 1982 through the Reconciliation Bill. Last year, you may remember that the Democratic controlled Congress enacted Reconciliation cuts reducing $8 billion from the deficit. The main point, however, is that we have been fooling ourselves. We have been cutting programs right along, and congratulating ourselves on the cuts. But we are almost to the point of trying to get blood out of the turnip. There isn't much there. There is still the need for additional budget cutting, but we will not reach a balanced budget with spending cuts alone. In order to eliminate the kind of deficits we're looking at now, and still preserve funding for defense and interest payments in the social "safety net" that the President has promised to maintain, we would have to cut approximately 60 percent of the rest of the budget in 1984. No Congress is going to make cuts on that order and no President is going to propose them.

ENTITLEMENT AND TAX EXPENDITURE PROGRAMS

Flaw number two was the decision that entitlement and tax expenditure programs were sacrosanct. Nobody underestimates the difficulty of tackling entitlements. Certainly I do not underestimate them. But the lesson of all the budget exercises we have been through thus far in 1981 is clear: there is no painless way to balance the budget. It can't be done by sleight-of-hand, public relations wizardry, or fine tuning. It requires a frontal assault against the excesses which have pushed your government and mine to its present budgetary condition. But the President chose not to lead, and not unexpectedly, Congressmen and Senators were not chomping at the bit to take this one on without Presidential support.

IMPOUND SPENDING

Flaw number three is the proposal to impound spending. Rather we should be impounding the tax cut. The impoundment proposal assumes, Mr. Chairman, that the Congress is going to appropriate more than is needed. There is nothing in the record of this Congress to support such an assumption. Consequently, there is no reason to give the President blanket power to impound spending. Uncontrolled Presidential impoundment would destroy the discipline of the budget process. I was here when Congress reasserted its constitutional prerogatives in fiscal matters against the illegal and unprecedented actions of the Nixon Administration. I did not participate in that exercise only to relinquish the same power in September of 1981. There is talk of the Administration's courage and bravery because it is willing to take this responsibility. There is talk about a proviso that both Houses have a veto over any impoundment, so that we would have a shared responsibility. That is the typical Washington solution—a shared approach with no fixed responsibility. It is bad. It breaks our fiscal discipline and destroys the credibility of the budget process we have worked so diligently to vindicate. How much better to have a fair fight, an up or down vote, on the Appropriation bills, and let the President, if he thinks there is too much money appropriated in any bill, veto it. I believe the mood in these halls is such as to sustain such action.

ADMINISTRATION UNDERESTIMATED MAGNITUDE OF ECONOMIC PROBLEMS

The summer confidence of August has turned to the doubting despair of September. It is apparent that the Administration underestimated the magnitude of the economic problems it confronted. It is clear that it is not just a matter of time until the new policy takes hold and turns America around. It is obvious that tinkering and patch work and fine tuning cannot salvage the misbegotten economics of the new theorists. It's not so simple as designating a sweepstakes winner in the Stockman-Weinberger debate.

White House and Capitol Hill are a cacophony of conflicting voices. The Majority Leader tells the Senate that Wall Street is addicted to the heroin of high interest rates. The Chairman of the Budget Committee advocates the McGovern program of cutting $30 billion from defense. Every day brings its new confusion and I am reminded of the old saying aboard ship, "When in danger, when in doubt, run in circles, scream and shout". What is wanting is not proposals, but a comprehensive proposal. What is wanting is not the desire for a solution, but the realization that there is no painless, piecemeal solution. The only viable approach is a comprehensive package addressing the stark budget choices we confront. In such a comprehensive solution, we will find real reconciliation. The Second Concurrent Budget Resolution which this Committee begins to address today offers us the opportunity for that kind of reconciliation.

PROPOSED REVENUE AND SPENDING CHANGES

Early on, President Reagan said: If you don't like my plan then submit an alternative. That is the kind of politics I understand. I submitted an alternative solely on the supply side, limited to $20 billion, rewarding savings and stimulating investment. That plan failed in spite of the fact that a majority of my Democratic colleagues here favored it. In the same spirit of trying to be constructive and of responding to the compelling urgency of the situation, I am today proposing a comprehensive package which I hope will eventuate as part and parcel of the Second Concurrent Budget Resolution. I would hope that the experience of the past few weeks would lend credence to the effort. Everyone around this table has been home during the recess and knows the stark impact of high interest rates on his or her constituents. Everyone around this table now understands that Wall Street and the financial community in general cannot be persuaded by pious musings and "sophomore psychology". We should all be able to see as of September 15, 1981 the effects of the President's program: huge deficits, stretching out as far as the eye can see, to the tune of $60, $70, $80, perhaps $100 billion and it's not just Wall Street that is affected by those deficits, because when the Government goes out to borrow the funds to keep up, private investors and consumers all across this land are unceremoniously bumped out of the capital market. Let's tell it like it is—the Administration assured us that if only Congress would put the program in place, the ecomomy would respond with a rush of new activity. The assurance was wrong. The economy has responded with incredulity. We cannot wait 6 months more for results. Interest rates are at their highest level in history, the housing and automobile industries are at rock bottom levels of activity. Congress is faced with the urgency in this Second Budget Resolution not of fine-tuning a game plan whose wisdom is already vindicated—it is faced instead with the need to remedy the defects of the program so recently approved. I believe that the package I am proposing today provides this remedy.

REVENUE AND SPENDING CHANGES

[Budget impact in billions of dollars]

	1982	1983	1984
Revenue changes:			
Smaller personal tax cut (in percent) (5/5/5)		+25.0	+40.0
Repeal indexing provision in tax bill			
Repeal oil industry tax breaks	+1.3	+1.7	+2.2
Repeal deduction for intangible drilling costs	+3.0	+3.5	+4.1
Windfall profit tax on natural gas	+15.0	+12.0	+9.0
Repeal consumer debt interest deduction	+6.0	+7.1	+8.0
Total revenue changes	+25.3	+49.3	+63.3
Spending changes:			
President's defense budget	−2.0	−5.0	−6.0
Reduced interest costs from lower interest rates	−6.0	−9.0	−12.0
Total spending changes	−8.0	−14.0	−18.0
Total reduction in the deficit	−33.3	−63.3	−81.3
Federal budget surplus or deficit (−) using CBO economic assumptions	−32.0	+8.0	+31.0
Federal budget surplus or deficit (−) using Hollings economic assumptions	−42.0	−17.0	

ECONOMIC ASSUMPTIONS

[Calendar years]

	1981	1982	1983	1984
Real GNP (percent change):				
Hollings	2.0	1.6	3.2	3.0
CBO	2.3	3.1	4.1	4.0
Administration	2.6	3.4	5.0	4.5
Consumer prices (percent change):				
Hollings	9.9	7.9	7.6	7.4
CBO	10.1	7.2	7.0	6.2
Administration	9.9	7.0	5.7	5.2
Unemployment rate (persons):				
Hollings	7.4	7.7	7.4	7.1
CBO	7.4	7.3	6.9	6.5
Administration	7.5	7.3	6.6	6.2
Treasury bill rate (percent):				
Hollings	15.0	14.2	12.7	11.7
CBO	14.5	12.4	11.4	10.1
Administration	13.6	10.5	7.5	6.8

PERSONAL INCOME TAX CUT

Now, Mr. Chairman, let me elaborate a little on these various points.

My first proposal would be for a smaller income tax cut. We simply cannot afford a large across-the-board personal income tax reductions. I like tax cuts. All politicians like tax cuts. But when we are decreasing defense spending by $100 billion, how can we afford to cut taxes by $200 billion? Something has to give; the numbers in the President's plan just do not add up to a balanced budget. And a balanced budget is what the people of this country want and what our economic condition compels. In poll after poll last year and this, the people put a balanced budget at the top of their list of priorities, followed by increased defense spending. To be sure, tax cuts are desired, but not before we balance the budget. The American people know, just as Wall Street investors know, that you cannot live forever on borrowed money. A government cannot operate on borrowed money without destroying the private economy.

The situation is that we now have a tax law which does not please the very people the Republican party wanted so badly to please—the business and investment community. It is not enough to say, "Wait, give it 1 more month or 2 more months or 6 more months." The country cannot wait. The atmosphere that was supposed to be created by the new tax law is myth. All the while, high interest rates are crippling our domestic economy and causing unprecedented havoc overseas.

What can be done about it? It's not too late, Mr. Chairman. But we must act now. We must undo the damage of that tax bill—the one James Schlesinger called the "single most irresponsible fiscal action of modern times"—by reducing the size of the second and third years of the across-the-board cut by half.

The administration's tax cut has devastated the revenue posture of the Government. The tax cuts cost us $93 billion in 1983, $150 billion in 1984, $199 billion in 1985, and $268 billion in 1986. The only outcomes guaranteed by that kind of revenue loss are budgeting in the red, high interest rates, and continued inflation. I worked on the last balanced budget we had in this country—the $3.2 billion surplus which Lyndon Johnson bequeathed his successor in 1969. Now, under the program I am proposing today, we will have after 15 years a balanced budget for fiscal year 1984. The American people will support this proposal because they understand that the alternative is high interest rates. They will support it because they understand that in the present environment, Kemp-Roth tax cuts provide no genuine relief. Once the budget is in balance and Government's fiscal house is in order, we can proceed with the kind of thorough-going and genuine tax relief which all of us want to have.

INDEXING TAX RATES

Second, I propose the immediate repeal of the ill-considered and hastily enacted provision for indexing the income tax. Indexing, scheduled to take effect beginning in 1985, was the most irresponsible provision of all in a bill made distinctive by its irresponsibility. If we start indexing tax rates, we will soon be unable to pay for even the bearest-boned Federal Government, national defense, and social security. I think even George Gilder would agree we need those programs.

OIL PROVISIONS

Third, I also recommend repeal of the oil provisions that were included in the tax bill. Quite candidly, I think that the Congress put politics above reason when it included the royalty income, stripper well and new oil provisions in tax act of 1981. How can the Congress justify such tax expenditures in light of the budget reductions that were just approved in the Reconciliation Act of 1981? Big Oil is making obscene profits. How can we propose reductions in social security and child feeding programs and at the same time give independent oil companies and royalty owners these unwarranted tax breaks? How can a member of Congress say that he or she is for a balanced budget in fiscal year 1984 and then turn around to spend $11.6 billion which can only exacerbate the deficit? The inclusion of these provisions in the tax bill was neither sound economic policy nor sound energy policy. I therefore recommend that these provisions be brought to the floor for reconsideration in the form of an amendment repealing the appropriate tax provisions.

OIL INDUSTRY TAX BREAKS

Fourth, I propose repeal of that provision of the internal revenue code of 1954 to eliminate the expensing of expiration and development costs of oil, gas, and mineral extraction. Since this tax expenditure was enacted, it has been justified as the stimulus to mineral exploration. However, since 1954 there have been significant changes in the energy situation of the United States. I need not recall all of these changes, but they eventuate, as we all know, in decontrol. Yet, despite all of these changes and despite "decontrol", the "intangible drilling cost" provision remains on the books. Presently, approximately 99 percent of the revenue loss associated with intangible drilling costs involves oil and gas exploration, and this loss is now equivalent to $3 billion per fiscal year.

NATURAL GAS DECONTROL

Fifth, I have long been and continue to be an ardent opponent of the decontrol of natural gas. The gas companies, and the oil companies which are entering the gas business very heavily, are making billions on natural gas in the present environment. However, it is apparent also that the Administration will soon submit, and the Congress will approve, legislation decontrolling natural gas. I have therefore come to the conclusion that we should proceed with immediate decontrol and with a windfall profits tax to mitigate the impact of decontrol. I would initially propose that this tax be for a period of 5 years or until such time as $40 billion in revenue has been raised.

I continue to be concerned with the impact natural gas decontrol will have on consumer purchasing power, especially low income residential consumers, and on the economy as a whole. Nevertheless, I can read the political omens and insofar as decontrol is concerned, the future is almost now. The only way to achieve decontrol while attempting to minimize its impact on the economy and on the consumer is to implement a natural gas windfall profits tax. Not only would this mitigate some of the unforeseen consequences of natural gas decontrol, but it would also provide needed revenues, thereby substantially reducing the Federal deficit.

CONSUMER DEBT INTEREST DEDUCTION

My sixth proposal is repeal of the consumer debt interest deduction. At a time when we are trying to balance the Federal budget and promote investment and savings, it no longer makes sense to encourage consumers to make all of their purchases on credit by allowing the interest on this debt to be deducted from taxable income. An economy concerned with increasing savings and productivity should not be in the business of allowing a tax write off for interest paid out while at the same time it taxes interest income. So, this change would be sound public and economic policy. Additionally, it will return $21 billion to the Treasury over the next 3 years.

DEFENSE BUDGET SAVINGS

Seventh, my proposal would go along with the President's recent announcement to reduce the size of the increases in the Defense budget. We can afford a few savings in this area, while still increasing overall Defense expenditures by 7 percent a year.

LOWER INTEREST COSTS FROM LOWER INTEREST RATES

Finally, the above proposals translate into lower interest costs from lower interest rates. The tax changes I have proposed today represent a responsible fiscal policy—the kind of fiscal policy which will open the way toward an eased monetary policy. No longer will the burden fall exclusively on the monetary side. Instead fiscal and monetary policy will be working together to achieve the kind of economic stability which has been so sadly wanting in America these past 15 years.

BALANCED BUDGET IN FISCAL YEAR 1983

The bottom line of the Hollings Plan, using the economic assumptions of the Congressional Budget Office, is a budget in balance for fiscal year 1983. There are those, myself included, who believe the CBO assumptions are optimistic, even though they are not nearly so rosy as the Administration's. But even under the less optimistic assumptions that I have worked up, we would still achieve a balanced budget for fiscal year 1984. This plan may strike some as being politically unpalatable, but it strikes me as economically and politically imperative. We are at a true cross-roads in public policy. The decisions we will be making this month and next will determine the future—America's future. Let us seize the moment boldly and enact the kind of comprehensive program which alone can get America moving again.

It requires no revelation from on high, no bright new economic insight, to fathom whither we must go. It requires only an appreciation of the good sense of the American people. They know what needs to be done in 1981 and they will sacrifice to achieve success. Sacrifice is the off-spring of leadership, and the present leadership in both the Executive and Legislative branches will fail America unless it faces up to the difficult choices confronting Government today. Those of us gathered around this table will shortly begin writing the next chapter of the story. I hope it is a chapter of vindication for a Government that has too often in the recent past failed to discharge its solemn responsibilities.

ECONOMY DOESN'T NEED INCREASED TAXES

Chairman **Domenici**. Do other Senators want to make opening remarks?

I would only suggest, Senator Hollings, I hope we can arrive at a bipartisan second resolution. Obviously, I cannot agree with your approach. I would just summarize it in one sentence. It is really, in a very real sense—I added up your tax increases and they only amount to, in round numbers, $140 billion increased taxes from wherever you get them.

Senator **Hollings**. Revenues, yes.

Chairman **Domenici**. Increased revenues, which is increased taxes.

I would just suggest that I do not think that is what this economy needs. That is precisely how we have done it in the past, whether we did it through overt acts or by failing to cut taxes as inflation pushed taxpayers into higher brackets. I have not had time to figure what $140 billion in new taxes, which is your package proposal for balancing the budget, does to what we have tried to do for the taxpayers and business people of America; but I think your proposal will be seriously considered, obviously, as everything is in this committee. We will have time to analyze that and see just what it means.

Senator **Hollings**. They are not new taxes, and they are not increases. Like you say, give us time. You have not really cut them yet.

Chairman **Domenici**. I understand.

Senator **Hollings**. I said do not cut them as much.

Chairman **Domenici**. I understand. Senator Hart?

OPENING STATEMENT OF SENATOR HART

Senator **Hart**. Mr. Chairman, I have long been of the view that we cannot balance the Federal budget, gain the confidence of the investment community—and therefore bring interest rates down—and have the massive personal tax cuts which the Congress has enacted. My own view is that we ought to defer those personal tax cuts, balance the budget, and then come back in consideration of such tax reductions. I have introduced legislation to achieve that. I hope this committee will give it consideration.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Mr. Chairman, I want to be as brief as Senator Hart in my opening comment.

I think it is increasingly clear that the new economic strategy has two conflicting halves. The fiscal half seems to press in the direction of stimulus for the private sector, and the monetary half seems to go in exactly the opposite direction. It is like driving an automobile with one foot pushed all the way down on the accelerator and your other foot pushed down on the brake as hard as you can. You don't go anywhere, the engine just races.

I think that is what we have with the continuation of the very high interest rates. I hope that your testimony would explain how, with that contradiction of monetary and fiscal policy, we can get the kind of real economic growth that you foresee. You hedge by saying that growth depends on favorable monetary policy, but that is not spelled out very clearly.

Chairman **Domenici**. Senator Quayle?

OPENING STATEMENT OF SENATOR QUAYLE

Senator **Quayle**. Mr. Chairman, I would just like to compliment Senator Hollings for at least bringing revenue changes again to the attention of this committee. I certainly do not object and think that perhaps this committee ought to get into some of the revenue changes and look at the revenue side as a potential area for balancing the budget. But let us give this tax cut a chance. It does not go into effect until October 1.

Everyone is talking about this radical tax cut that we have had in this country. Basically what we are doing is establishing the rate of taxation we had in this country in 1978. That is not a radical tax cut. It is just slowing down the high taxes that were scheduled to go into effect if we had not done anything.

We have got the revenue side that we can look at. We have defense to look at. We can look at social security, the entitlement programs. We can look at cuts in discretionary programs.

I would hope that this committee would just give this tax cut a chance and not bury it.

Senator **Hollings**. It is working. That is your difficulty. You folks do not understand. Your tax cut is working. They see it. There are smart business people all over this country. They are regular citizens like you and me that invest and work, and they cannot see anything but government in the red through Ronald Reagan's second term. That is what you have guaranteed.

Senator **Quayle**. Senator, I don't——

Senator **Hollings**. That's what they see.

Senator **Quayle**. I don't believe that the only way——

Senator **Hollings**. You have to change that perception at least.

Senator **Quayle**. I do not believe that the only way that we are going to get out of the red and into the black, which we have not done since 1969, is to tamper with the tax bill that we just passed. There are other revenue changes that we can discuss and look at, but I would hope that we would not start to go right back in and say we are going to fiddle with that tax bill that has not even gone into effect. Let us look at some other revenue aspects. I do not disagree with the Senator on that and will be glad to join him in an effort to look at some of the revenue aspects that we might be able to pursue, but leave the basic precepts and concepts of the tax bill as passed and see if it is going to work. Give it a year at least.

MONEY MARKET PEOPLE NEED TO BE CONVINCED

Chairman **Domenici**. Let us proceed. I think it is fair to make one observation. I do not think it should go unnoticed that early in Senator Hollings' remarks he indicated that he does not agree with the Congressional Budget Office economic projections for 1982, 1983, and 1984. The truth of the matter is that, even with the deficits, if in fact we are able to come up with the unidentified cuts that are still our responsibility, no new cuts, just those, the Congressional Budget Office has predicted that this tax cut and the economic recovery plan—not Mr. Stockman—but they predict that it will work. In fact, their economic assumptions are tremendously optimistic for 1982, 1983, and 1984.

So, I agree with you, Senator. As far as burying a program before it starts, I am not going to be part of that. That is why we have these kinds of people here. She is going to tell us that her economic people almost agree with the economic forecasts of the administration and, with the exception of interest, agree with the first budget resolution in most regards. In unemployment and growth, they are almost right on.

The issue is how do we convince, if that is what is necessary, the money market people that we have some control over this budget. That is the issue and that remains for us to accomplish. It does not require, in my opinion, the kind of repeal of the tax proposals as suggested by the Senator, but that is what the committee is for. We will debate it.

Dr. Rivlin, I think you ought to have as much time as you need to explain your report to us, in particular the economics and the deficits. So if you will, please proceed now as you see fit.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY WILLIAM BEEMAN

Dr. RIVLIN. Thank you, Mr. Chairman. I am delighted to be back before this always lively committee as you face the very difficult task of working on the second concurrent resolution.

My testimony today will present the updated economic forecast of the CBO and our estimate of the budget outlook. We issued last week a slightly longer version explaining how we got to where we are, which I hope you will make part of the record.

Chairman DOMENICI. Without objection, your report, "The Economic and Budget Outlook: An Update," will be included in the record.[1]

Dr. RIVLIN. CBO's updated economic forecast shows substantial improvement in the economy compared with the lackluster performance of recent years. The slowing of inflation that began in the first half of 1981 is projected to continue into 1982. Real growth is expected to pick up late in 1981 and to be strong in 1982. The major reasons for the projected improvement in economic growth are the moderation of inflation and the reduction in taxes contained in the Economic Recovery Tax Act of 1981.

This forecast of strong real growth and moderating inflation depends critically on two highly uncertain factors. First, the economic projections assume that there will be no upsurge in commodity prices such as the shocks in food and fuel prices that contributed to the economy's poor performance in the last several years. Second, money growth, consistent with Federal Reserve targets, could prove to be incompatible with strong economic growth. We are not predicting that, but it is a major area of uncertainty.

Even with the projected improvement in the economy, CBO anticipates a budget deficit of about $65 billion in fiscal year 1982, declining gradually to about $50 billion in fiscal year 1984. These projections assume the spending policies of the first concurrent resolution on the budget for 1982, which include still-unspecified spending cuts for 1983 and 1984. The CBO projections thus indicate that sizable spending cuts or revenue increases beyond those contemplated in the first resolution would be needed to achieve the target of a balanced budget in 1984.

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[1] See p. 452.

CBO'S ECONOMIC FORECAST FOR 1981

Economic activity has been sluggish recently and is expected to show little or no improvement until the end of 1981. Correspondingly, for the remainder of the year the unemployment rate is likely to remain near the 7- to 7.5-percent range experienced since the beginning of the year. Although inflation, as measured by the Consumer Price Index, may worsen a bit for a while before it gets better, by year's end a reduced pace of inflation should be in evidence. Interest rates are also expected to begin moving downward later in the year. I know I told you that before, but we still expect that will happen before the end of the year. It will be in response to the improved inflation picture and an assumed pickup in the growth of money, M_{1B}, which has recently been below the low end of the Federal Reserve's target range.

CBO'S ECONOMIC FORECAST FOR 1982

The CBO economic forecast for 1982 indicates that real growth will be strong compared with that in 1981 and in the last several years. Inflation is expected to continue to decelerate. From the fourth quarter of 1981 to the fourth quarter of 1982, real gross national product is forecast to increase by about 4 percent, while inflation, as measured by the GNP implicit price deflator, is projected to moderate to a rate of about 7 percent. Interest rates, although lower than in 1981, should remain high in 1982 because of reduced money growth and strong credit demands. The unemployment rate is also expected to turn down in 1982. The forecast is summarized in table 1.

TABLE 1.—THE CBO FORECAST

Economic variable	Actual	Projected	
	1979:4 to 1980:4	1980:4 to 1981:4	1981:4 to 1982:4
Nominal GNP (percent change)	9.4	9.2–13.4	9.3–13.5
Real GNP (percent change)	.3	1.5– 3.5	3.1– 5.1
GNP implicit price deflator (percent change)	9.8	7.6– 9.6	6.0– 8.0
Unemployment rate (percent, fourth quarter)	7.5	7.1– 8.1	6.6– 7.6
3-month Treasury bill rate (percent, calendar-year average)	11.6	13.5–15.5	11.4–13.4

The strong growth projected for 1982 is a consequence of the slowed pace of inflation and the tax cut. The moderation of inflation is expected to reduce prices faster than wages, thereby stimulating real income growth, which in turn will lead to stronger demands. The recently enacted cuts in individual and business taxes will also increase consumer purchasing power and stimulate business investment in 1982. Although interest rates will remain high, they are projected to decline next year, thereby inducing more real growth, particularly in residential construction. Growth in money aggregates at the upper end of the Federal Reserve's target ranges is expected to be consistent with a moderate easing of interest rates, because of the projected decline in inflation and innovations in financial markets that are expected to promote further economies in the use of money balances.

CBO'S ECONOMIC FORECAST BEYOND 1982

In the years beyond 1982, CBO assumes that inflation will continue to decelerate. Real growth will remain relatively strong. Interest rates will continue their downward trek, and the unemployment rate will decline somewhat. In brief, the CBO economic assumptions for the period 1982-84 contrast sharply with the unfavorable economic developments of the past several years.

REAL GROWTH

The basic outlook for economic activity—slow growth for the remainder of 1981 with improvement in 1982—has not changed since the CBO's forecast of last winter. The actual pattern of real growth in the first half of 1981 was close to that anticipated by CBO's winter forecast: The very strong performance in the early months of the year was followed by substantial weakening in the spring. The projected slowness of growth for the remainder of 1981 has not changed significantly, largely because interest rates have remained high, even somewhat higher than in the CBO winter forecast.

INFLATION

On the other hand, inflation has moderated more than projected earlier. The principal reason for the reduction in the inflation rate during the first half of 1981 were the very favorable price developments in the food and energy sectors and a higher value of the U.S. dollar on the world's currency exchanges. These favorable price breaks, which were not foreseen by forecasters 6 months ago, have reduced inflation and improved the present outlook for real growth. CBO now projects about 4 percent growth during 1982, as compared with our winter forecast of nearly 3 percent. This revision in the forecast is almost exclusively the result of the improvement in the outlook for inflation. The CBO forecast of continued improvement in inflation is in turn based on the assumption of no adverse movements either in world commodity prices or in the dollar exchange rate over the near term. Moreover, the reduced inflation momentum is expected to slow wage inflation and reduce interest rates, outcomes that make room for higher real growth and somewhat reduced unemployment rates.

FOOD AND ENERGY PRICES

Recognizing the critical importance of commodity prices in the CBO forecast highlights the elements of uncertainty involved in it. Food and energy prices and the foreign exchange value of the dollar have historically been very volatile. Thus, if poor weather, unrest in the Middle East, or other uncontrollable factors should once again cause sharply increased food or energy prices, the economic outlook would be much less optimistic. On the other hand, a decline in energy prices would have a favorable impact on the economy.

MONEY GROWTH

Another area of uncertainty concerns the relationship between economic activity and money growth. Some analysts, apparently including the Federal Reserve, argue that the Federal Reserve's targets for money growth are not consistent with strong economic growth, given the rates of inflation projected by most forecasters. The CBO forecast may be optimistic on this issue, but, given the projection of a decline in inflation and prospective changes in financial regulations and institutions, we do not believe it is overly optimistic.

BUDGET OUTLOOK

The major budgetary implications of the CBO economic forecast and longer run economic assumptions relative to the first budget resolution targets are: lower revenues, largely as a result of somewhat lower projected economic growth and personal income levels; higher outlays, principally for interest on the public debt and other interest-rate-sensitive programs; and, hence, greater deficits.

REVENUE PROJECTIONS

CBO's revenue projections, which are based on current tax law as revised by the Economic Recovery Tax Act, indicate that total revenues will rise from an estimated $605 billion in 1981 to about $655 billion in 1982 and to about $750 billion in 1984, as set forth in table 2. This represents an average annual growth rate of about 7 percent—less than one-half of the average growth rate since 1976.

TABLE 2.—FEDERAL BUDGET ESTIMATES FOR FISCAL YEARS 1981–84

[In billions of dollars]

Budget aggregates	1981	1982	1983	1984
First budget resolution:				
Revenues	603.3	657.8	713.2	774.8
Outlays	661.35	695.45	732.25	773.35
Surplus or deficit (–)	–58.05	–37.65	–19.05	1.05
Administration:				
Revenues	605.6	662.4	705.8	759.0
Outlays	661.2	704.8	728.7	758.5
Surplus or deficit (–)	–55.6	–42.5	–22.9	.5
CBO:[1]				
Revenues	605	653–658	693–703	740–755
Outlays	665	718–723	748–758	790–805
Deficit	60	60–70	45–65	35–65

[1] Based on existing tax law as revised by the Economic Recovery Tax Act of 1981 and the spending policies specified by the first budget resolution.

Sources: First Concurrent Resolution on the Budget for Fiscal Year 1982 (H. Con. Res. 115, approved May 21, 1981); "Mid-Session Review of the 1982 Budget," July 15, 1981; Congressional Budget Office.

CBO's revenue projections are very close to the first resolution target for 1982 but are lower by about $15 billion for 1983 and by more than $25 billion for 1984. The CBO revenue projections are also lower than the administration's July estimates by about $7 billion in 1982, $8 billion in 1983, and $11 billion in 1984. The differences between the various estimates are attributable largely to different economic assumptions, set forth in table 3, and to the fact that the timing and size of the actual tax cuts enacted in August were somewhat different than those assumed for the first budget resolution.

TABLE 3.—A COMPARISON OF ECONOMIC ASSUMPTIONS

[By calendar year]

Economic variable	1981	1982	1983	1984
GNP (billions of current dollars):				
First budget resolution	2,941	3,323	3,734	4,135
Administration	2,951	3,296	3,700	4,097
CBO[1]	2,931	3,255	3,624	4,018
Real GNP (percent change, year over year):				
First budget resolution	2.0	4.1	5.0	4.5
Administration	2.6	3.4	5.0	4.5
CBO[1]	2.3	3.1	4.1	4.0
GNP implicit price deflator (percent change, year over year):				
First budget resolution	9.7	8.6	7.0	6.0
Administration	9.6	8.0	7.0	6.0
CBO[1]	9.1	7.7	7.0	6.6
CPI (percent change, year over year):[2]				
First budget resolution	11.1	8.3	6.2	5.5
Administration	9.9	7.0	5.7	5.2
CBO[1]	10.1	7.2	7.0	6.2
Unemployment rate (percent, annual average):				
First budget resolution	7.5	7.2	6.6	6.4
Administration	7.5	7.3	6.6	6.2
CBO[1]	7.4	7.3	6.9	6.5
3-Month Treasury bill rate (percent, annual average):				
First budget resolution	13.5	10.5	9.4	8.2
Administration	13.6	10.5	7.5	6.8
CBO[1]	14.5	12.4	11.4	10.1

[1] The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecast; they are assumptions.

[2] The Consumer Price Index used by the administration is for wage earners and clerical workers in urban areas; the index used for the first budget resolution and CBO assumptions covers all urban dwellers.

Sources: Conference report on the First Concurrent Resolution on the Budget—Fiscal Year 1982 (to accompany H. Con. Res. 115, reported May 15, 1981); "Mid-Session Review of the 1982 Budget" July 15, 1981; Congressional Budget Office.

OUTLAY PROJECTIONS

On the spending side, CBO projects total unified budget outlays to rise from an estimated $665 billion in 1981 to between $718 billion and $723 billion in 1982, and to between $790 billion and $805 billion in 1984. This would represent an average growth rate of about 6 percent annually—again, less than one-half of the average growth rate since 1976. The CBO projections, which are based on the spending policies implicit in the first budget resolution, exceed the first resolution outlay targets by over $20 billion in 1982, and by similar amounts in 1983 and 1984. They are also higher than the administration's July estimates by about $15 billion in 1982, $20 billion in 1983, and nearly $40 billion in 1984.

CBO's projected outlays are higher for two major reasons. First, higher estimates of interest on the public debt and other interest-related costs; and, second, higher estimates of defense outlays. The higher interest costs result largely from CBO's assumption that interest rates will decline less rapidly between 1982 and 1984 than projected by the administration or assumed in the first resolution targets. The higher CBO defense outlay projections represent technical estimating differences about how quickly budget authority, especially for defense procurement programs, will spend out during the next several years.

Other differences between the CBO outlay projections and the administration's estimates result from somewhat different assumptions about the size of annual cost-of-living adjustments for social security benefits and other indexed programs and from technical reestimates for farm price supports, food stamps, medicare and medicaid, and assistance payments.

DEFICIT PROJECTIONS

CBO's budget projections indicate that the budget deficit for 1982 would be about $65 billion, or over $25 billion higher than specified by the first concurrent resolution and more than $20 billion higher than estimated by the administration in July. Over the next 2 years, the CBO budget projections indicate that the deficit would fall gradually to about $50 billion in 1984.

ADDITIONAL OUTLAY REDUCTIONS

The CBO spending projections assume that additional spending cuts will be made, over and above those contained in the Omnibus Budget Reconciliation Act of 1981, through the appropriations process and by other legislative and administrative means. For 1982, the additional outlay reductions implicit in the first budget resolution targets amount to about $15 billion. They consist of such items as further savings in social security benefits, reduced appropriation levels for discretionary programs, and administrative savings from accelerated collection of outstanding debts owed to the Federal Government and other efficiencies. These further reductions in 1982 would also reduce outlays in 1983 and 1984 by similar amounts.

In addition, the first budget resolution targets include unspecified reductions of $20 billion for 1983 and $28 billion for 1984 that were not distributed by functional categories. If these additional spending reductions do not materialize, of course, budget outlays and deficits could be substantially higher than projected by CBO.

Similarly, if the economy is weaker than projected, as a result of higher interest rates or less rapid productivity growth, for example, the Federal budget deficit in 1984 could exceed $50 billion by a considerable margin.

BUDGET PROBLEM

Although the enactment of the Budget Reconciliation Act represents a major step toward achieving the spending reductions proposed by the administration last March and embodied in the first resolution targets, the Congress still has ahead of it the very difficult and painful task of identifying further cuts. Moreover, the CBO budget projections indicate that these additional spending reductions may have to be even larger than now being contemplated if a balanced budget is to be reached by 1984 on the spending side.

I would like to conclude my statement this morning with some illustrations of why it is so difficult and painful to reduce spending sufficiently to balance the budget by 1984.

REVENUE GROWTH

The enactment of the Economic Recovery Tax Act puts in place the goal of both the administration and the Congress to reduce growth in Federal revenues and the Federal tax burden. During the next 3 years, revenues are projected to grow by a small rate than the economy as a whole. Consequently, revenues as a percent of GNP are projected to decline from 21 percent in 1981 to 19 percent in 1984.

SPENDING REDUCTIONS

The sharp curtailment of revenue growth over the next several years will require even greater reductions in Federal spending relative to GNP in order to achieve a balanced budget by 1984. Federal outlays as a percentage of GNP now stand at 23 percent. Thus, to reach a balanced budget by 1984, spending would have to be reduced relative to GNP by 4 percentage points in the next 3 years. Such a sharp reduction in Federal spending has not occurred since the end of the Korean war, when Federal outlays fell from 21 percent of gross national product in 1953 to 17 percent in 1956. All of that reduction was in national defense spending, which fell as a percentage of GNP from 13.8 to 9.6 percent over that period.

The situation is now markedly different. The administration and the Congress are committed to substantial real growth in defense spending. Under the CBO budget projections, defense outlays would increase relative to gross national product, from 5.6 percent in 1981 to 6.7 percent in 1984. Nondefense programs are the principal targets for major spending reductions. Spending for nondefense programs, relative to GNP, would have to be cut by more than 4 percentage points, from over 17 percent in 1981 to less than 13 percent in 1984, a level that last existed in 1970.

Some of this reduction of spending relative to gross national product will occur without any additional spending cuts by the Congress. For example, as interest rates moderate, the relative size of interest costs will fall automatically. Also, as the unemployment rate declines, spending for unemployment benefits will fall relative to the gross national product. With the spending cuts already made by the Reconciliation Act, and with the assumed decline in interest and unemployment rates, 1984 spending for nondefense programs would be reduced to about 15 percent of GNP, under CBO's projections.

But this still leaves a considerable way to go to reach a target of under 13 percent of GNP for nondefense outlays by 1984, the level that would be necessary to achieve a balanced budget and allow for the projected growth in defense spending without changing the tax laws. The question is, Where can these savings be found?

About three-fourths of nondefense spending today consists of benefit payments for individuals—such as social security, medicare, Federal employee retirement, unemployment compensation, and public assistance—and for net interest costs. Most of this spending is mandatory under existing law. CBO projects that outlays for these two categories will grow from about $385 billion in 1981 to about $480 billion in 1984. With defense outlays in 1984 projected at about $260 billion, and total revenues at about $750 billion, this would leave very little room for any other Federal spending if there is to be a balanced budget. These numbers are set forth in table 4.

TABLE 4.—FEDERAL BUDGET OUTLAY ESTIMATES FOR MAJOR PROGRAM CATEGORIES—THE ADMINISTRATION'S JULY ESTIMATES ADJUSTED FOR CBO ECONOMIC ASSUMPTIONS AND ESTIMATING METHODS (BY FISCAL YEAR)

	In billions of dollars				As a percent of GNP			
	1981	1982	1983	1984	1981	1982	1983	1984
National defense	161	193	226	261	5.6	6.1	6.4	6.7
Benefit payments for individuals	316	341	367	393	11.1	10.7	10.4	10.0
Net interest	68	81	87	86	2.4	2.6	2.5	2.2
Other Federal operations and grants to State and local governments	120	105	103	102	4.2	3.3	2.9	2.6
Unspecified savings to be proposed by the administration			−30	−44			−.8	−1.1
Additional spending cuts (or revenue increases) to reach administration deficit targets for 1982 to 1984		−22	−32	−50		−.7	−.9	−.3
Total	665	698	721	748	23.3	22.0	20.4	19.1

Alternatively, the projected growth in defense spending would have to be scaled back, the benefit programs would have to be cut more than proposed to date by the administration or assumed in the first budget resolution, and or additional revenues would have to be generated. Otherwise, the goal of achieving a balanced Federal budget would have to be postponed.

Moreover, to achieve substantial spending reductions in 1984, most of the actions will have to be taken in 1982 and 1983. A large portion of the 1984 defense budget, especially for procurement programs, will be determined in 1982 and previous years' appropriations. With respect to benefit payments and grants to State and local governments, time must be allowed for the Congress to enact legislation and for the recipients to adjust to reduced funding levels. Thus, the budget problem facing the committee is not only difficult and painful, its solution cannot be delayed.

Thank you, Mr. Chairman.

FEDERAL DEFICIT KEEPS INTEREST RATES UP

Chairman DOMENICI. Thank you very much, Dr. Rivlin.

I think we will follow the same format that we did early on this year. We will try to keep our questions to 5 minutes. We will try to go through as Senators arrive. I understand, Senator Hollings, that almost all of your side arrived at the same time with the exception of Senator Biden and Senator Metzenbaum. So, I would just move down the line with the exception of coming back.

Dr. Rivlin, are the Federal deficits the cause of the currently high interest rates? If Congress were to hold the 1982 deficits to

$42.5 billion, should we expect an immediate improvement in the interest rates?

Dr. RIVLIN. There is no single cause of the high interest rates. Interest rates reflect inflation expectations, the demand for money, and the supply of money. But a Federal deficit requires the Federal Government to borrow money and to compete with other users of credit for the available supply. Other things being equal, the Federal deficit does keep interest rates up.

It is very difficult to say how fast interest rates would come down if the deficit were reduced. One should not expect any immediate miracle.

WHY DEFICIT ESTIMATES DIFFER

Chairman DOMENICI. Let me ask you to recap for us. Assume the reconciliation levels for the discretionary appropriation bills are met. What accounts for the difference between $42.5 billion and your estimate of the deficit for 1982?

Dr. RIVLIN. Assuming that the first concurrent resolution targets are met, we still think that the deficit would end up at about $65 billion rather than $42 billion. About $7 billion of that is on the revenue side. We are expecting somewhat lower revenues.

Chairman DOMENICI. And most of that lower revenue is because of the good news of oil prices remaining constant, the windfall profits tax will pick up less revenue?

Dr. RIVLIN. Some of it is that, and some of it is lower income tax revenues from a slightly lower assumed rate of growth.

Chairman DOMENICI. What are the other items?

Dr. RIVLIN. If you take out $7 billion, that leaves about $15 billion in outlay estimating differences. About $6 billion of that is interest related—that is, higher interest rates and the higher deficit. About $5 billion is higher estimates of defense spendout; that is, looking at the historical data, we project that the already appropriated funds for procurement will spend out faster than the administration and the Congress in the first resolution were assuming.

Chairman DOMENICI. What else?

Dr. RIVLIN. The other $4 billion is accounted for by technical estimating differences that relate to food stamps, medicare, farm price supports, and several other programs.

Chairman DOMENICI. Other than your estimate of $5 billion on military outlays, which is an estimate of outlay expenditure flowing from the budget authority for defense, other than that the rest of it is not attributable to the appropriation process. Is that correct, in your assumption of $65 billion?

Dr. RIVLIN. No; we are assuming that the appropriations will move along as contemplated in the first resolution.

AVERAGE GROWTH OF EXPENDITURES

Chairman DOMENICI. How much was the average growth in the Federal budget for previous years versus what you estimate the growth in expenditures to be from now through 1984, at present levels of expenditures and current law, assuming reconciliation?

Dr. RIVLIN. Between now and 1984, expenditures will be growing at a rate of about 6 percent, according to our estimates. That is about half of the growth rate for the last several years.

Chairman DOMENICI. Senator Quayle?

BALANCED BUDGET BY 1984 REQUIRES ADDITIONAL CUTS

Senator QUAYLE. Dr. Rivlin, to get the nondefense programs down to 15 percent of GNP, you indicate the current policy will get us there.

Dr. RIVLIN. Yes; our estimate is that, given what you have already decided to do, these programs would come down to about 15 percent of GNP by 1984.

Senator QUAYLE. And, if we do not do anything on further nondefense spending and the entitlement programs, and if we do not do anything on the revenue side of the ledger, how much more would we have to take out of defense to achieve the balanced budget in 1984?

Dr. RIVLIN. The numbers are set forth in table 4.[1] Basically, the table shows that, in order to get to a balanced budget by 1984 without changing taxes and keeping the defense level where it is projected to be, you are going to have to find approximately an additional $94 billion. You could make spending cuts anywhere you want; you could also provide for increased revenues. I do not think anyone can say exactly how much would have to come from cuts in defense spending.

Senator QUAYLE. Are you saying that the deficit would be $94 billion?

Dr. RIVLIN. No; I am saying that, if——

Senator QUAYLE. Current policy.

Dr. RIVLIN [continuing]. With current policy, which includes——

Senator QUAYLE. Nondefense at 15 percent of GNP.

Dr. RIVLIN [continuing]. Which includes $44 billion in cuts that are already agreed to but as yet unspecified—now I am using the administration's numbers—and if you accept our estimate that, even assuming the cut of $44 billion, you would have a $50 billion deficit, then somehow to bring the budget into balance on the spending side, you would have to specify $94 billion.

Senator QUAYLE. So, basically, if we did not cut further in nondefense areas and we did not touch the revenue side, you are talking about $50 billion more above the unspecified cuts that have somewhat been agreed to. Is that correct?

Dr. RIVLIN. That is right.

Senator QUAYLE. This does not include any of the off-budget expenditures?

Dr. RIVLIN. No. Now we are talking about the unified budget, on budget.

TAX EXPENDITURES

Senator QUAYLE. Last year you gave us a rather lengthy list of so-called tax expenditures on the revenue side, that Senator Hollings and I were talking about earlier. Could you prepare a priority list for us of, say, four or five of these revenue-gaining measures or tax expenditures that you would recommend this committee and the Congress look into full speed ahead?

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[1] See p. 23.

Dr. RIVLIN. We never make recommendations, Senator.

Senator QUAYLE. Hypothetical statements.

Dr. RIVLIN. We could certainly give you a list. Senator Hollings has suggested a few this morning. One that I think is fairly attractive—if one is concerned about the state of the economy, about productivity and investment, and about moving over some years from consumption to investment—is the suggestion of repealing or modifying the deduction of consumer interest. There are reasons other than increasing revenues for considering it. It seems to me that the sensible thing to do is to look at the list of tax expenditures and see which ones have some other arguments going for them in terms of economic growth in addition to just the revenue effects.

I might mention another possibility for consideration that politically would be very difficult. One might suggest some kind of a limit—I am not suggesting repeal, but some kind of a limit—on the deduction of mortgage interest. The deduction might be limited to, say, $5,000, or the deduction on second homes might be excluded. That would also have some economic argument on the grounds that, as a nation, we do put an awful lot of our potentially investable funds into housing. Discouraging that to some extent and moving the incentive toward more productive investment might also be a useful thing to do.

[The following material was subsequently supplied for the record:]

Some of the other reductions in tax expenditures that have been suggested include the following:

Ending or limiting the tax exemption on small-issue industrial revenue bonds,
Taxing all unemployment compensation,
Limiting the exclusion from tax of employer-paid health insurance,
Repealing the home insulation tax credit,
Limiting the foreign tax credit for oil and gas income,
Repealing the oil depletion allowance, and
Taxing a portion of Social Security payments.

Senator BIDEN. That could be called the Quayle amendment.

Senator QUAYLE. Only if I get Biden to support me. Delaware would like that, I am sure.

Senator BIDEN. I am sure they would.

Senator QUAYLE. Thank you, Dr. Rivlin. I appreciate your rather upbeat testimony, particularly in lieu of the fact this last 30 days there has been a lot of prediction of doom and gloom. I certainly commend you for it.

Chairman DOMENICI. Senator Chiles?

BALANCED BUDGET BY 1984

Senator CHILES. Dr. Rivlin, I want to continue with your upbeat testimony. I want to get the numbers straight on what it will take to balance the budget in 1984.

As I read your report, where we are at this point, there is a $50 billion gap in 1984, assuming we make $50 billion more in cuts in the reconciliation. Is that right?

Dr. RIVLIN. That is about right.

Senator CHILES. So, if we do not make those cuts, then we are talking about a $100 billion gap.

Dr. RIVLIN. Yes; approximately.

Senator CHILES. Well, if we take the President's plan and we cut back $6 billion in defense, then we have got to cut $94 billion out of the rest of the budget. If we leave out the $227 billion in defense and the $69 billion in net interest—we cannot legally cut that—then that $94 billion has to come out of the remaining $507 billion, which adds up to about 19 percent across the board—cutting all the other items in the budget, including social security, medicare, veterans pensions, all the programs—it would be about 19 percent across the board. If we exempt social security and medicare, then we would have only $263 billion left of the budget in which to find that 94 billion dollars' worth of cuts. So, then we would have to cut the remaining programs, which would include veterans, education, food stamps, water projects, energy, roads, by about 36 percent to balance the budget in 1984.

Do you think it is possible for the Congress to cut 36 percent across the board in these items?

Dr. RIVLIN. Well, only you know what is possible, but it clearly implies very drastic cuts. To put it even more dramatically, I think, you could look back at my table 4.[1] If you were to keep defense at the level now contemplated, and exempt the benefit or entitlement programs from further cuts, and meet the required interest expenditures, then, in order to find nearly $100 billion, you have to close down the rest of the Government. It is that simple. That, clearly, is not going to happen. So I think it follows that either you have to operate on the revenue side or that defense and the entitlements have to take part of the cut. Or you have to abandon the balanced budget concept. Those are the only choices you have.

FISCAL AND MONETARY POLICIES

Senator CHILES. Over the last 6 years the committee has stressed the need to coordinate fiscal and monetary policy. Many of us feel that the huge tax cut has put fiscal policy on a collision course with the monetary policy. Your report shows that starting today with reconciliation and the tax cut signed into law, without further cuts we face deficits of $80 billion in 1982, $90 billion in 1983, and $100 billion in 1984. When you add the $20 billion of off-budget borrowing to those figures, then we get a Federal impact on the credit market of over $100 billion for each of the next 3 years. That comes at a time when private credit demand is very high and is even likely to grow in response to the investment incentives in the tax bill. Yet the administration has said it wants to see a continuation of the tight money policy.

Does it look like to you that our fiscal and monetary policies are on a collision course?

REASONABLE GROWTH RATE POSSIBLE DESPITE TIGHT MONEY

Dr. RIVLIN. I think it is very hard to say. As I said in the testimony, it is one of the great uncertainties of the moment as to whether it really is possible to have strong economic growth and tight money with high interest rates at the same time.

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[1] See p. 23.

As we look ahead, we think there is a pretty good chance that you can operate both policies at once, in the sense that inflation has already come down and we expect it to come down some more. We expect that, even with the tight money policy, interest rates will come down somewhat in the next few months and will then continue slowly down.

Senator CHILES. Give a range of that "somewhat."

Dr. RIVLIN. We are assuming a 91-day Treasury bill rate for this calendar year of about 14.5 percent. This means that we would have to come down to about 13.5 percent for the last quarter of the year from well above 15 percent, where we are now. That is modestly optimistic though not as optimistic as the administration is.

It is by no means certain that interest rates will come down, but we do feel that it is likely that they will and that a reasonable growth rate will resume in 1982 despite the tight money policy. But it is an area of very great uncertainty.

Senator CHILES. Speaking of that uncertainty, what about the uncertainty of, even if they come down in the last quarter, whether the monetary policy as set for next year is going to accommodate the kind of growth that you and the administration are projecting for next year?

I am struck by the comparison that you present. Table 7 of the CBO report (p. 478) shows the Federal Reserve only projects a 2.5-percent real growth for 1982 while you are projecting 4.1 percent.

Then on page 482 you point out that the Federal Reserve has stressed that its monetary targets will not be eased to accommodate additional growth in the GNP.

What makes you think that they will allow your 4.1-percent projection to occur if their projection is only 2.5 percent?

Dr. RIVLIN. You are clearly right that we are more optimistic than the Federal Reserve, and we have been for some time. Reasonable people can differ.

Our reasons for optimism are that inflation has already come down a good deal, and we expect it to come down some more. We expect that to allow some real growth. We expect that the velocity of money will continue very high and will increase somewhat.

VELOCITY OF MONEY

Senator CHILES. Let me ask you about velocity. My understanding is the administration is talking about growth figures of around 13 percent next year. If the Fed is talking about allowing the money supply to grow by 4 percent, then you are talking about a velocity of 9 percent. Have you ever heard, is there any history to show that we have ever had a 9-percent velocity for a year?

Dr. RIVLIN. We are actually showing a velocity of M_{1B} of about 7 percent, growing at nearly 6 percent, which is high. It is——

Senator CHILES. Has that ever occurred for a year?

Dr. RIVLIN. It has occurred historically. Let me get Bill Beeman to say a word about velocity.

Mr. BEEMAN. Velocity growth of about 6 percent has occurred for periods of a year or so. But velocity is extremely volatile.

Senator CHILES. Can you tell me what year?

Mr. **Beeman**. The most recent experience was during the years ending in the first quarter of 1979 and 1976.

Senator **Chiles**. Is that an extremely high velocity, to go 7 percent for a year?

Dr. **Rivlin**. Yes; it is an extremely high velocity. The velocity has been high. One reason for thinking it may remain high is the high interest rates themselves, which give everybody a reason to economize on money. Another reason is changes in financial arrangements themselves as, for instance, the growth of money market accounts.

RELATIONSHIP BETWEEN VELOCITY AND INTEREST RATE

Senator **Chiles**. Let me ask you this just to finish up. If the velocity continued, went at 7 percent, what the heck would happen to the interest rate? If you had that kind of a demand for the 4 percent of the money growth that was out there, what would that do to the interest rate?

Dr. **Rivlin**. We are assuming some decline in the interest rates.

Senator **Chiles**. I would like to know, Mr. Beeman, if you will tell me, back in the historical context, when you had a velocity of 7 percent, tell me what happened to the interest rate during that time you had that velocity.

Dr. **Rivlin**. The high velocity is normally associated with high interest rates, but we have got high interest rates, and we have got even——

Senator **Chiles**. But you are associating high velocity and lowering interest rates.

Dr. **Rivlin**. We see lowering interest rates somewhat, but not to anything any of us would like to consider low or even moderate, at a time when inflation is coming down. It is hard to find a set of historical circumstances exactly like these, which is what makes it so uncertain.

Senator **Chiles**. I just was wondering what happened to the interest rates when we had this velocity once of 7 percent.

Mr. **Beeman**. If you look at the relationship between M_{1B} velocity and interest rates, you will find, much to the surprise of most people, that they do not move together closely. In fact, if you were to chart quarterly changes of the two, they would not look like they are associated. I have done this, and I can show you such charts. A more complex analysis of money demand, however, incorporating other variables, does show that high velocity tends to be associated with high interest rates.

Our forecast has interest rates coming down modestly by about 2 percentage points from 1981 to 1982. We do not think that that is an unreasonable forecast for three reasons: first, the moderation that we have in inflation; second, the slowing growth in credit demands that we expect——

Senator **Chiles**. But there is not going to be a slowing growth in credit demands in 1983 and 1982, is there? That is when the tax cut——

Mr. **Beeman**. That is what increased real growth and reduced inflation will do. With lower inflation people need to borrow less. Third, we have the——

Senator **CHILES**. When you have got strong economic growth because of the tax cut?

Mr. **BEEMAN**. That is true. Nominal GNP growth is expected to be something like 11 percent next year, with inflation declining and a cyclical recovery in real activity that is generally associated with high-velocity growth.

I wanted to mention third, that the Money Control Act of 1980 had a major impact on financial institutions that will encourage rapid growth in money velocity. It will provide new institutional arrangements whereby individuals will find new ways to economize on M_{1B}. And it is already occurring.

Chairman **DOMENICI**. Lawton, see, I knew the answer was going to be not what you wanted; that is why I encouraged you to ask it.

Senator **CHILES**. Oh, I love the tooth fairy.

Chairman **DOMENICI**. Senator Johnston?

STRONG GROWTH EXPECTED IN 1982

Senator **JOHNSTON**. Thank you, Mr. Chairman. Dr. Rivlin, as I read your statement I am certainly reassured. I read phrases like "substantial improvement." You talk about real growth will be strong; inflation is expected to decelerate. And there are other phrases and figures throughout the statement. It seems to say that the plan is working. Is that the impression you mean to give to us?

Dr. **RIVLIN**. What it says is that we are expecting quite strong growth in 1982. We said that in March. What has changed since March is not the Reagan program; it is the world, principally the world oil price and what happened to food prices. We were assuming the Reagan program in our March forecast. We said then we expected a reasonably healthy growth rate in 1982. The only reason it is more optimistic now is that we have had good luck on the oil price, good luck on food, and good luck, in a sense, on the value of the dollar.

CUTTING SPENDING AND TAXES NOT UNHEALTHY FOR ECONOMY

Senator **JOHNSTON**. You understand, I want to believe, and I think the country wants to believe. Can we follow through with the plan? Or do we have to change the plan? Do we have to say that the plan was fatally flawed in some respects?

Chairman **DOMENICI**. Senator, would you repeat that please? Someone had my attention.

Senator **JOHNSTON**. Yes; can we continue on the plan as projected and have these good substantial improvement indicators? Or is the plan rather fatally flawed, as some economists are calling it Dunkirk, and Armageddon, and various other endearing adjectives? I am just wondering. Can we expect it to work continuing on the way that it was projected for us?

Dr. **RIVLIN**. What our projections imply is that, if you achieve what the Congress said it wanted to do in enacting the Tax Act and the first budget resolution, the chances are you will have a reasonably healthy economy in 1982 and beyond. There are things that could go wrong with that. But cutting back both on the tax side and on the spending side is not an unhealthy thing to do for the economy.

What I am saying to you is that you set yourself a very difficult task. The spending cuts that would have to materialize in order to achieve even the $50 billion deficit by 1984 are still very substantial. Without additional spending cuts, you will have very much larger deficits than contemplated by the Congress plan.

1984 DEFICIT ESTIMATED AT $50 BILLION

Senator JOHNSTON. Well, as contemplated by the Reagan plan, the cuts that he proposed to us last year, we follow that through and then the deficit would exceed the $50 billion you have here, would it not, for 1984?

Dr. RIVLIN. No; if you assume what the President has proposed and roughly what you enacted in the first concurrent resolution, and if you actually get all those cuts, then our estimate is that you would still have about a $50 billion deficit in 1984.

Senator JOHNSTON. One very important point, to me at least, is this. Assuming it is a $50 billion deficit, in order to wipe out that deficit you have to cut more than $50 billion because of the negative reflow phenomenon, do you not?

Ms. RIVLIN. Probably.

Senator JOHNSTON. Only probably? I mean, is not that a well-known phenomenon——

Dr. RIVLIN. Yes; I think that is probably right.

Senator JOHNSTON. In order to get to that $50 billion, about what would you have to cut on the average? I understand that there are different amounts, different negative reflows, and different categories, but on the average how much do we have to cut?

Dr. RIVLIN. That is a very difficult thing to answer. The reason why I said "probably" rather than "certainly" is you have the additional uncertainty of the impact of cutting the deficit on interest rates. If cutting the deficit really has a psychological effect that helps bring interest rates down and stimulate growth, then the spending cut necessary to balance the budget might not be much greater than $50 billion.

Senator JOHNSTON. It is more than just that. You have unemployment from those who were cut off Government jobs. You have unemployment insurance and increased food stamps and all of those things.

Dr. RIVLIN. That is right.

Senator JOHNSTON. It is on the order of what, of 3 to 2, is it not something like that? You have to cut three to get two?

Dr. RIVLIN. That depends on the state of the economy. I would hate to give a number without thinking about it. We can do some work on that.

Senator JOHNSTON. Well, I mean, you have given the number $50 billion here. Rather than have that stick in our minds, we ought to think more in terms of what, $60 billion and beyond? Or $100 billion if you want to have the $44 billion unspecified.

In other words, to get $100 billion out of that deficit, give me a range of numbers. You have ranges of numbers here. What would you have to cut on ranges of numbers to get $100 billion saving?

Dr. RIVLIN. I really do not know. I do not want to give you a number that is off the top of my head. I would rather think about it. It is a very complicated question. If you are saying if you did cut an additional $100 billion from the budget assumed in these projections, what would it do? And I do not know.

Senator JOHNSTON. It is very clear, though, that to get $100 billion cut——

Dr. RIVLIN. Remember, we have already assumed the $44 billion. It is in——

Senator JOHNSTON. Did you assume $44 billion in cuts gave you a $44 billion reduction?

Dr. RIVLIN. We are assuming that, if you take all the cuts, specified and unspecified, in the first budget resolution, you will still end up with roughly a $50 billion deficit.

Senator JOHNSTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Hart?

DEFER PERSONAL TAX CUTS TO BALANCE BUDGET

Senator HART. Dr. Rivlin, two questions. If we were to defer the personal tax cuts in the so-called Kemp-Roth tax plan, could we balance the Federal budget in 1983?

Dr. RIVLIN. I do not remember exactly how much those are worth.

Senator HART. $71.1 billion.

Dr. RIVLIN. It depends upon what you think would happen to the economy if you did that. This gets back to the reflow question. But, if you really had $71 billion more revenue in 1983, presumably, yes.

Senator HART. You project a deficit in 1983 of $55 billion. Is that correct?

Dr. RIVLIN. Yes.

Senator HART. And the revenue loss from the personal tax cuts, primarily the Kemp-Roth rate reduction and the marriage penalty tax, is $71.1 billion for 1983.

Dr. RIVLIN. Right.

Senator HART. Which would give you a surplus, given your assumptions, of $15 billion in 1983?

Dr. RIVLIN. Not exactly because, if you are assuming a different policy, you have to determine what that does to the economy.

RESPONSE OF FINANCIAL MARKETS TO DEFERRING TAX CUTS

Senator HART. I understand. Well, what it has done for the economy so far is not a lot.

What in your estimation would be the response of the financial markets if the Congress were to take steps legislatively to defer those tax cuts for the next 24 months?

Dr. RIVLIN. I do not know. I find the response of the financial markets pretty mystifying at the moment. There is clearly a concern about the size of the deficit.

Senator HART. What is mystifying about it? They are hardheaded business people. They know just exactly what you said earlier and everyone else has testified before this committee has said: Federal deficits cause the Government to borrow; that crowds out private borrowing; that runs up the interest rates. What is mystifying about that?

Dr. RIVLIN. I think that is not the only thing that affects interest rates. As we and other economists look ahead, we see the Federal deficit coming down as a percentage of gross national product, probably not causing a terribly serious crowding out problem. Federal borrowing as a percentage of total borrowing is highest when non-Federal borrowing is small, when the economy is weak.

I am not saying it is totally mystifying. On the other hand, we do see inflation coming down. We see a reasonably healthy economy.

Most forecasters that I know of expected that, as the economy slowed down, credit demand would ease off and interest rates would come down somewhat.

Senator HART. But it has not happened.

Dr. RIVLIN. I find that somewhat mystifying.

Senator HART. I think it is clear that the Government of the United States has to start dealing with reality and not with expectations, or hopes, or belief, or theories. The realities are that the financial markets have discounted this economic plan heavily, that they are not going to react differently, presumably, until we do something else to produce further reductions in deficits. We can do that in the ways we have been talking all morning: additional spending cuts. Or we can defer the personal tax cuts. My strong choice is the latter.

I believe that, if we did that—if we would commit this country to a balanced budget in the next 24 months—the market would respond almost immediately. And the Federal Reserve Board would respond to the market's response. And interest rates would come down. Then we would not have the wholesale bankruptcies I think we are going to have and, in fact, we are already having.

Thank you, Mr. Chairman.

COMPARISON OF GNP GROWTH

Chairman DOMENICI. Senator Metzenbaum, I wonder if you would just permit me to place a little comparative chart in the record. It answers Senator Johnston's questions with reference to what is the difference, is the plan under their economic assumptions really going to work.

What I will put in the record, Dr. Rivlin, is a comparison of GNP growth for years 1979, 1980, and 1981, compared with your projections, not the President's, for real GNP growth for 1982, 1983, and 1984. It will reflect that the real growth is, on an average, more than double the previous 3 years on real CPI average, not quarter over quarter. It will reflect that the CPI was 11.6 percent on an average and, under yours, it will be reduced to 6.8 percent. Unemployment: practically no change. The only significant change remains in the T-bill rate in that it does not come down proportionately to the other two. It remins rather consistent with the 3 previous years.

Chairman DOMENICI. Is that a fair summary of what you have found?

Dr. RIVLIN. That sounds like a fair summary of what we project, with maybe more than our usual caveats about the uncertainty of the situation. I would like to see that chart, however, and examine those numbers more closely.

COMPARISON OF ECONOMIC TRENDS: 1979–81 VERSUS 1982–84

[Percent change, prior year]

Real GNP				CPI			
Actual		CBO		Actual		CBO	
1979	3.2	1982	3.1	1979	11.3	1982	7.2
1980	–.2	1983	4.1	1980	13.5	1983	7.0
1981	[1] 2.3	1984	4.0	1981	[1] 10.1	1984	6.2
Average	1.8	Average	3.7	Average	11.6	Average	6.8

[Percent, actual rate]

Unemployment				91-day T-bill rates			
Actual		CBO		Actual		CBO	
1979	5.8	1982	7.3	1979	10.0	1982	12.4
1980	7.1	1983	6.9	1980	11.5	1983	11.4
1981	[1] 7.4	1984	6.5	1981	[1] 14.5	1984	10.1
Average	6.8	Average	6.9	Average	12.0	Average	11.3

[1] CBO estimate.

Chairman DOMENICI. Senator Metzenbaum?

INTEREST RATES

Senator METZENBAUM. Ms. Rivlin, I remember several years ago when you appeared before our committee. I talked with you at that time about high interest rates and said: Aren't high interest rates in and of themselves inflationary? I remember you said at that time that, yes, but it takes time. And you start off with the high interest rates and that, long-rangewise, they are anti-inflationary.

Well, it has been a long time. High interest rates are still with us. I am concerned that you and Mr. Volcker have not taken into consideration a factor that never existed before in our history. That is that the tight money policy causes high interest rates. As a consequence, there are billions of dollars coming back into the country, both Arab dollars and Eurodollars, that are flowing back in to take advantage of those high interest rates. So, we are not really winning the battle against inflation as far as the money supply is concerned, and we have a new factor not being taken into account.

Is it not time for this Nation to attempt to bring down the interest rates? I note that the morning paper indicates that Mr. Regan and Mr. Wiedenbaum are now talking about nudging the Federal Board along that line.

Senator Hawkins and I will introduce legislation shortly to give the President authority to put in place a brandnew Federal Reserve Board, similar to the procedure that occurred in 1935, when they just totally eliminated one Board and put in a new one.

I am wondering whether it would not serve our Nation's interest to move in that direction at the moment rather than to kid ourselves about nudging the Board and that somehow this tight money market is going to help us solve the problem of inflation.

Dr. RIVLIN. Well, nobody likes these high interest rates, not even Paul Volcker. Clearly, the high interest rates are making it very difficult for small business, for farmers, and for others. They are slowing down the economy. In particular, they are affecting the housing industry dramatically, drastically. There is no doubt about that.

We certainly would be happy to see interest rates come down and indeed have projected that they will come down somewhat over the next few months. But there is danger on the other side if the Federal Reserve were to reverse course and start increasing the money supply at rapid rates. That would bring short-term interest rates down, but the question is what would then happen to inflation.

LOWER INTEREST RATES WITHOUT INCREASING MONEY SUPPLY

Senator **Metzenbaum**. Is it possible to bring down interest rates through the Fed without directly increasing the money supply? Are not other procedures as well as jawboning available to the Fed? Could they achieve lower interest rates just by some action on the part of the leadership?

Dr. **Rivlin**. I doubt it. There are, of course, ways of regulating interest rates directly, but that is like regulating prices directly. An interest rate is a price; it is the price of money. It does reflect the demand and supply phenomenon.

UNSPECIFIED CUTS

Senator **Metzenbaum**. You had indicated something about the unspecified cuts, $44 billion in 1984, $30 billion in 1983. Are those figures over and above the figures that were brought to the fore in the closing days of the budget battle last year, when there was $27 billion, assuming a 1-percent cut in each function including defense for waste, fraud, and abuse, assume passage of legislation increasing Presidential impoundment powers, and additional cuts not yet proposed? And then a footnote, "Included in Senate Budget Committee reestimated but actual savings are doubtful because cuts are unspecified." And the other one says, "but actual savings are questionable."

My question is this: Are your figures of $44 and $30 billion over and above these pie-in-the-sky $27 billion for 1983 and $35 billion for 1984 that we put into that last budget?

Dr. **Rivlin**. They are comparable. In enacting the budget resolution, the Congress did not do exactly what the administration had proposed, but instead specified some of the cuts in lieu of others unspecified. But we are assuming that the administrative savings that were assumed as well as the other savings that were assumed in the first resolution will take place. That is the basis of the estimate.

Senator **Metzenbaum**. Can you tell me, it has now been many months since the first budget resolution was enacted. Do you have any evidence that the saving of 1 percent for the WFA program—the Democrats had a WPA; the Republicans got a WFA program, waste, fraud, and abuse. But, as far as I can find out, that is just a real conversation. You cannot find it. I have been trying to find it, the Department of Defense. I tried to find it other places. The only thing I really find is that we are going to make relish and catsup and mustard a vegetable under the school lunch proqram. But I do not see any other waste, fraud, and abuse. And that is hardly waste, fraud, and abuse, in my opinion.

Dr. **Rivlin**. I think that would be a good question to ask David Stockman when he appears before this committee. It must be said that fiscal 1982 has not started yet.

EFFECT OF TAX BILL ON PROJECTIONS

Senator **Metzenbaum**. In your projections as to the past projections, did you anticipate that the tax bill would almost totally eliminate estate taxes? Did you anticipate that this session of Congress would eliminate $33 billion in windfall profits on the oil companies, that is during the period between now and 1990? Were those taken into account previously? How have you made adjustments for them in your present projections?

Dr. **Rivlin**. The actual tax act did differ somewhat from that assumed in our previous projections. But the difference was not enough to affect macroeconomic estimates, which have a large band of uncertainty.

ESTATE TAX CUTS

Senator **Metzenbaum**. How much would they lose just on estate tax cuts alone, which I had never before heard about until suddenly they appeared on the horizon and they became a reality? How much do we lose on the estate taxes alone?

Dr. **Rivlin**. According to the conference report, in 1982 the estate and gift tax provisions would amount to about $2 billion in lost revenues.

WINDFALL PROFITS TAX

Senator **Metzenbaum**. How much does it say the windfall profits tax will take away? The repeal.

Dr. **Rivlin**. The energy tax changes, as a whole, amount to about $1.7 billion. This is for 1983.

Senator **Metzenbaum**. You have got about almost $4 billion there alone in changes.

Dr. **Rivlin**. That is what those add to, yes.

Senator **Metzenbaum**. Those were not anticipated in earlier projections, and you do not consider them to be of sufficient dimension to be significant?

Dr. **Rivlin**. It depends what they are significant for. Changes of that size are not significant for a forecast of the gross national product, if that is what you are talking about. If you are talking about a more specific kind of forecast, say for the oil industry, they are not trivial at all.

Senator **Metzenbaum**. No, I'm sure. Thank you very much, Mr. Chairman.

Chairman **Domenici**. Senator Riegle?

Senator **Riegle**. Thank you, Mr. Chairman.

I know you have been seated there for a long time. I have a couple of things that I want to walk you through.

Dr. **Rivlin**. That is what I am here for.

Senator **Riegle**. OK.

Chairman DOMENICI. Senator, could I explain my absence to you? I am going to have to leave. Senator Quayle will preside. Senator Chiles has some questions for the record. I would appreciate your answering them as quickly as possible.[1]

Senator Quayle has indicated he has 10 or 15 minutes. So, Senator, you ought to have adequte time to make your points. I wonder if you would yield 1 minute to me.

Senator RIEGLE. Of course I will yield to my colleague and friend.

LACK OF CONFIDENCE IN MONEY MARKET PEOPLE

Chairman DOMENICI. Dr. Rivlin, when I look at your economic projections, the only significant economic indicator that you do not find responding in a major way is the interest rates although your average for the 3 years is lower than the previous 3 years. Would you discuss this proposition with me? It appears to me that, if there is anything that is on the scene, it is the lack of confidence in the money market people to whether or not the cumulative effect of budget deficits over the next 3 or 4 years will be any—whether there will be any significant improvement in that. Looking at yours and others, it is almost business as usual in terms of cumulative debt.

It seems to me that is an indication, if that is the reality, that we have not managed the budget or the deficit any better than we have in the past. It is my assumption that, if there is a strong indication that that is not true and it will be better in terms of management of the deficit than in the past, that that is the remaining issue in terms of confidence on the horizon.

Would you just take a moment and tell me whether you think that is a fair assessment?

Dr. RIVLIN. It is very hard to say, but I think it probably is a fair assessment. A lot depends on getting inside the heads of people who handle large amounts of money, but it seems clear that much of the lack of confidence is related to a feeling that the administration and the Congress will not follow through on their plan and will not in fact bring the budget deficits down.

Chairman DOMENICI. Thank you very much.

Senator RIEGLE. It is late in the morning. A lot of folks are disappearing.

Dr. RIVLIN. Everybody is hungry.

MONEY GROWTH COULD BE INCOMPATIBLE WITH ECONOMIC GROWTH

Senator RIEGLE. That, I am sure, includes the two of us.

I have long had great regard for you, as you know. However, I think the presentation today, if I may say so in a kind way, masterfully evades the seriousness of the problem that we face right now.

There is a very skillful use of words. Government reports too often are so good at disguising problems that they, in a sense, disappear right before your eyes.

I want to refer specifically to two things in your summary. One is that you lead with the suggestion that the economy may be headed for substantial improvement, yet there is the caveat at the bottom, which gets lost, that says: "money growth consistent with Federal Reserve targets could prove to be incompatible with strong economic growth." In other words you seem to be saying that we now have a monetary policy that is going to wreck the economic improvement that you forecast. Putting it in in this form sidesteps a severe problem. It is a tip of the hat toward the problem, but it does not really lay out exactly how severe the monetary constraint is. I think there is an obligation to do so here.

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[1] See p. 44.

MATH DOES NOT WORK

Second, you say that, even with the projected economic improvement, you foresee deficits of $65 billion in 1982, $55 billion in 1983, $50 billion in 1984. All of this rests on the assumption that other major unspecified spending cuts in 1983 and 1984 will take place. Well, that is a very generous assumption, a very important one, a key one.

You state your assumptions, but I do not think it is fair to say that these enormous qualifiers, are put forward here in a way that puts everybody on notice as to how hard it will be to make this thing work.

Virtually every analyst who is looking at this new policy, virtually everybody else who is adding up all the numbers is coming to the conclusion that the math does not work. That is what everybody is saying.

I say everybody—let me give you some examples. I will insert some of this material in the record.[1] The New York Times had a major story on Friday, September 11, that is headlined "What the Bond Market Wants: Proof Sought Inflation Will Be Controlled." It quotes Robert Shomaker, Thomas Johnson, Leon Karvelis, Seth Glickenhaus, Felix Rohatyn, and others. The article includes the most concerned commentary from them that the problems with the administration's program are far more serious than is being presented here today.

The Wall Street Journal of September 11 headlines, a very long feature piece: "Many Wall Streeters Regret They Helped Pass Reagan Tax Bill." It goes on at great length. I will not read it.

U.S. News & World Report has a headline on a September 14 story: "Why Reagan Faces Uphill Fight on Wall Street. Huge deficits and surging interest rates have made the President's program suspect. Result: demand for massive new budget cuts."

Fortune magazine, September 7: "The Deficit"—says the headline on the story, "Worse Than Reagan Thinks." It goes on in the same vein.

ECONOMISTS DISCOUNT CUTS

The front page of the New York Times today says that Wall Street asks new budget trims and changes in the Reagan program. It says that economists discount cuts. And this is how it reads:

> A broad range of Wall Street economists said yesterday that President Reagan's cuts in military spending did not even qualify as a gesture toward easing the concerns of the financial markets, that his economic program will be inflationary. In interviews the economists asserted that, if military spending were not cut more, the President would have to seek further huge reductions in social programs, some

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[1] See p. 449.

form of tax increase, or a reduction in high interest rates. It might be easier politically to rescind part of the tax cuts, said Aubrey Freedman, labor economist at the Conference Board, a business-sponsored economic research organization, than go through the additional cutbacks in defense and social program spending that will be required. If the President is to reach his deficit target, something is going to hve to give.

What we are really talking about, said Leonard Santow, senior vice president and economist for the J. Henry Schroeder Bank & Trust Co., is a complete reassessment of the entire Reagan program and the premises upon which it was based. In his view the administration is, "finally coming to realize what the financial markets realized a long time ago, that the tax cuts have tied their hands on the receipts side. * * * Unless they cut more spending or introduce some new form of taxation, the Government deficit in 1982 will be inflationary, $15 to $20 billion more than these $42.5 billion that they have projected."

GET SPECIFIC ABOUT INTEREST RATES

Now, Dr. Rivlin, these people are saying to you, to us, and to the administration that it is time to take a cold shower of reality. It is time to talk about what is really happening. It seems to me that today you must get very specific about what has to happen to interest rates over specific time periods like, for example, the next 90 days and the next 180 days. Your testimony says in softball language that if the Federal Reserve does not cooperate, if there is not a response in monetary policy that is compatible with the needs of economic growth, then this whole economic plan can go awry. That is what everybody else is saying loudly and clearly.

My question would be this: What has to happen in monetary policy? What has to happen to interest rates over the next 90 days, over the next 180 days, to get us to a point where the math does start to work on the President's program? What must happen for these Doubting Thomases, who represent virtually the entire range of economic thought in the country from left to right, to begin to change their attitudes and say yes, the math can work.

Please be as precise as you can.

TREASURY RATE HAS TO COME DOWN

Dr. RIVLIN. I do not think we have been vague about either what has to happen on interest rates or what has to happen to the budget to get where you have said you all wanted to be.

On interest rates, as I said earlier in response to a question, perhaps before you came in, we are projecting that we will have a 14.5-percent Treasury bill rate for this calendar year. To achieve that, given what has already happened earlier in the year, the fourth quarter has to come in around 13.5 percent. That does not seem out of the realm of possibility. Now, what would bring that about? Conceivably, some easing in the direction of increasing the rate of growth in M_{1B}. The Federal Reserve has some room to do that. M_{1B} has been coming in below even the low end of their targets.

Senator RIEGLE. Let me just stop you there so I make sure that we have all got it straight. You are assuming that the long treasury rate has to come down to 13.5 percent in the fourth quarter? Is that right? That is what you feel is necessary?

Dr. RIVLIN. That is what it would take, approximately, to get to our calendar year average.

Senator RIEGLE. Where will we be for the third quarter?

Dr. RIVLIN. The third quarter is where we are now.

Senator RIEGLE. I know, but what is the rate?

Dr. RIVLIN. 15.5 percent.

Senator RIEGLE. So, you are saying that in the next quarter we have got to have a 2-percentage point improvement. It has got to go from 15.5 to 13.5 percent.

Dr. RIVLIN. Roughly, yes.

Senator RIEGLE. Do not misunderstand me. I happen to be a strong supporter of yours, past and present. But I think it would have been useful to have that stated right up front in this document so that everybody understands what is being said here. When you do not say something as important as that, you finesse the problem.

So you say that rates have to come down 2 points quarter to quarter——

Dr. RIVLIN. The example is for short-term rates. But I do not think we were vague about what we were assuming about interest rates. We are less optimistic than the administration about that.

Senator RIEGLE. Nevertheless, your assertion here is that you have got to go from 15.5 to 13.5 percent quarter to quarter. That is what must happen if the rest of your forecast is to hold together.

Dr. RIVLIN. That is what is consistent with our interest rate projection. Forecasting is very complicated. You cannot say that everything depends on some little piece of it.

INTEREST RATES ARE CRITICAL ISSUE

Senator RIEGLE. To understand your economic projections, however, we have to understand what future events they are based on. The critical issue, I think, is interest rates. Most people feel that is perhaps the single most important factor here.

So, you are looking for a 2-percentage point improvement in the fourth quarter. Now, let us say that does not happen. Let us hope it does. But let us say the rates stay where they are. How serious a deviation would that cause in your forecast?

Dr. RIVLIN. I do not think one can say exactly. If the decline in interest rates is delayed somewhat, the projected recovery would be a little later, and some people are projecting that. But it really depends on what happens in the next year. We are expecting a modest decline in interest rates over the next year, which we think is consistent with the rest of the forecast. We cannot say exactly when that will occur. We have been wrong before. We projected that interest rates would come down sooner than they have; so did everybody else. But, in order to get the kind of growth rates we are asuuming, you do have to have some decline in interest rates.

Senator RIEGLE. I think it is important to realize that your projections are based on getting started in the quarter with a large improvement in interest rates.

What about the first quarter of next year? What do you foresee?

Dr. RIVLIN. We never publish quarter-by-quarter projections of the economy or of interest rates. All I was giving you was an illustration of what is needed to get to our annual year rate since the year is already three-quarters completed.

Senator RIEGLE. All right. Looking at calendar 1982, then, what does your projection call for in terms of a further change in the interest rates?

Dr. RIVLIN. Still sticking with the Treasury bill rate, we are talking about another point down, to around 12.4 percent as the midpoint of our range for calendar 1982.

Senator RIEGLE. 12.4 percent; so, on an annual basis, you feel interest rates must hit 12.4 in order to make the rest of the projection hold together as you anticipate?

Dr. RIVLIN. I would not pin the whole forecast on one number.

Senator RIEGLE. No.

Dr. RIVLIN. I am just saying that is what is in our projection.

Senator RIEGLE. Well, it is a very important element. If that interest rate improvement happens and if other assumptions are right, then we might expect to see the economic improvement that you talk about, but if it doesn't, we won't.

The great concern that members of this committee are expressing is that the bulk of opinion, correct or not, does not anticipate that kind of an improvement over the next 90 days.

Dr. RIVLIN. May I comment on that? The commercial forecasters cover a wide range in their projections for 1981 and 1982. But most people see a slow 1981 and a pickup in 1982. And we are about in the middle of the range. It is not that everybody is more pessimistic than we are.

BOND MARKET OUTLOOK

Senator RIEGLE. If someone were buying bonds and could pick up a 2-percentage point improvement over 90 days, would not that make bonds a pretty good buy today?

Dr. RIVLIN. Yes.

Senator RIEGLE. I would agree. But let me just note what some of the people who have some standing in this area have just said about the outlook for the bond market. Let us just take Seth Glickenhaus, who is one of those featured in the New York Times article. He says, "Anyone who buys a bond today to hold for more than 5 years is out of his mind."

That is fairly blunt.

Here is Leon Karvelis, whom I mentioned earlier, from Merrill Lynch: "The bond trader today is not a supply-sider and not monetarist. He's a pragmatist."

Here is Felix Rohatyn: "The bond market today can be divided into two categories: the general disaster and the total shambles."

Here is the vice president of the Mellon Bank: "I can assure you that my clients will not chastise me if I forgo the opportunity to invest in long-term bonds."

And it goes on in that vein.

Senator QUAYLE. Without objection, the articles will be inserted into the record.[1]

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[1] See p. 449.

TREASURY BORROWINGS

Senator RIEGLE. Dr. Rivlin, you may well be right, and everybody else out there who is at the moment holding a contrary position may be wrong. Someone asked you about Treasury borrowings in the fourth quarter. As you know, the volume of activity will be up over the third quarter. I gather that you feel that is something that can be readily accommodated by the market? You think that the rate can drop two points despite the fact that the Government will be in the market as a credit seeker in a larger way than was true in this quarter.

Dr. RIVLIN. Yes.

Senator RIEGLE. What do you base that on? I do not understand why some people think that is a big problem, and you apparently feel exactly the opposite.

Dr. RIVLIN. If you look at what the Government has borrowed as a percentage of the overall level of credit, it has gone up and down. It is not extraordinary at the moment.

LOOK AT DEFENSE AND ENTITLEMENTS FOR ADDITIONAL CUTS

Senator RIEGLE. Well, I guess you have made that clear. You are not concerned about that level of borrowing in this coming quarter.

I just want to make one comment about the other cuts that are going to have to be found, presumably. You did not mention the defense issue specifically, not that you should have. From what you are saying about unspecified cuts that are yet to be found, it appears that most of the outside analysts who have looked at the defense plan over the last week are right. The Reagan administration is going to have to make a much more substantial reassessment of the defense increases. They are going to have to scale back the increase in defense spending to help reduce this deficit and try to enable this plan to work.

Dr. RIVLIN. I thought, if I may say so, Senator, that we did hit pretty hard on the general problem before you, which is that, if you are going to find the additional cuts and if you are exempting entitlements and defense, there is very little left. I think it follows from that that you should look at defense and entitlements.

Senator RIEGLE. I think that is true. Again, it is the use of words. You know, one can make the point by inference or one can step right up and say: Look, let's not kid ourselves; you are going to have to make major cuts in these functions unless you want to abandon the plan. That is basically what it boils down to. It is not very politic to do that, but I think we are at a point now where there is a general degree of alarm. We all better take the cold shower of reality together and be very blunt about what has to happen.

I hope the Federal Reserve and the people who have power over monetary policy will pay attention to what you have said about the change in interest rates that is needed right away in order for your numbers to hold together. That is a very powerful signal. I hope that piece of information gets out of this room and to the people who are going to make the decisions.

Thank you, Mr. Chairman. Thank you, Dr. Rivlin.

Senator **Quayle** [acting chairman]. Thank you, Senator. Thank you, Dr. Rivlin, for fine testimony. I enjoyed seeing you again. The committee is adjourned.

[Whereupon, at 1:05 p.m., the meeting was adjourned.]

Written Questions From Senator Chiles to CBO Director Alice Rivlin and the Responses

ESTIMATES OF TOTAL GROWTH IN MAJOR ENTITLEMENT PROGRAMS

Question 1. Dr. Rivlin, we are all concerned about the growth of entitlement programs and the pressure that puts on the budget. However, much of the discussion I have heard makes it sound like all the growth is due to inflation indexing. Since the bulk of entitlement programs are for retirees, they are also affected by the rapid increase in the older population. The third component is the increased utilization of services, particularly medical services, by eligible persons.

Would you please give us your estimates of the total growth in major entitlement programs (social security, medicare, veterans' benefits, civil service retirement) from now through 1984, and tell us how much is due to indexing and how much is caused by the other factors?

Answer. We estimate a $78.3 billion growth in the major entitlement programs between fiscal year 1981 and fiscal year 1984. Approximately 83 percent of this increase is due to increases in prices. Most of the remaining growth results from population increases, particularly among the older population groups (see table below).

[In billions of dollars]

Major entitlements	Growth fiscal year 1981-84	Growth from price increases	Growth from increased utilization of services	Other (including population shifts)
Social security	47.3	42.2		5.1
Medicare	22.4	16.6	3.1	2.7
Civil service retirement	6.9	4.2		2.7
Veterans pensions	.3	.5		−.2
Supplemental security income	1.5	1.4		.1
Total	78.4	64.9	3.1	10.4

ENTITLEMENT GROWTH: CAPPING MEDICARE

Question 2. Dr. Rivlin, one of the budget cutting suggestions floated by our distinguished Chairman is to cap the growth in Medicare. While I am as concerned about the growth in health care costs as anyone is, I wonder how it would be possible. In Medicaid, you are making a grant to the states, so you can cap the grant and let the states pick up the excess. In retirement benefits, if you cap the COLA you just write a smaller check. But in Medicare, we agree to pay individual health care providers the cost of whatever care is given to eligible people. So if you are going to cap the cost increase, you have to enact something like hospital cost containment, or else you are going to have to deny individuals the right to use health care. Isn't that correct?

Answer. Senator, you are correct that limiting growth in Medicare outlays to a precise percentage increase is a complex endeavor. I interpreted the Chairman's suggestion of a 10 percent cap, however, as a target amount for the impact of any cuts in Medicare rather than a specific policy change.

The growth in Medicare outlays can be trimmed, basically, in three ways: cutting reimbursements to providers, cutting benefit amounts through some form of cost-sharing, and raising Part B premiums. An example of an option to slow the growth in reimbursements to providers would be extending the current limits on hospital reasonable costs to include ancillary services. As another approach, benefit amounts could be reduced by requiring patients to pay a portion of costs from the second through thirtieth days of a hospital stay. Finally, Part B premiums paid by enrollees could be increased to cover a larger share of the costs of that program. Such a change would reverse the trend of enrollees' premiums covering a declining share of Part B costs.

UNCERTAINTY PREMIUM IN INTEREST RATES

Question 3. Dr. Rivlin, your report says that there is a lot of uncertainty in your forecast, particularly about monetary policy. I believe the Senate Majority Leader has stated it more strongly, calling the outcome of the President's economic program a "Riverboat Gamble." I have heard some economists say that one part of high interest rates is an uncertainty premium.

How much of an uncertainty premium do you think it is reasonable to have, given your calculations of the deficits for 1983 and 1984?

Answer. There is no unambiguous measure of the uncertainty premium in interest rates.

Most economists decompose interest rates into the sum of three components: (1) a real interest rate, (2) an expected inflation rate premium, and (3) an uncertainty or liquidity premium. None of these components, of course, is observable. While some surveys of inflationary expectations exist, for example, they are often found to be deficient. Many empirical studies use extrapolative techniques to capture the formation of inflation expectations. Some studies employ the argument that the announcement of future policy is potentially important in the determination of inflationary expectations.

Liquidity premiums are widely believed to be higher (1) the longer the maturity of the instrument, (2) the greater the variability of interest rates, and (3) the higher the level of interest rates. In addition, changes in either financial institutions or financial instruments might lead to changes in desired portfolios by maturity that would alter the structure of liquidity premiums prevailing in the market.

An expanding federal government deficit (say, as a percentage of GNP) is an economy in which resources are being employed at high rates of utilization, would be expected to lead to higher real interest rates, increased inflation expectations, and enlarged liquidity premiums. However, in an economy where resources are not being fully employed, and in which deficits are falling relative to GNP, the federal deficit should not be placing significant upward pressure on interest rates. The CBO economic assumptions and budget estimates for 1983 and 1984 reflect the latter situation.

The interest rates used by the CBO in these budget estimates are thought to be consistent with the assumed state of the economy and the federal government deficit. However, interest rates are very difficult to predict in the current environment, and their determination is due to a multitude of factors. Perhaps the most important of these is the stance of monetary policy over the period. The CBO economic assumptions imply improving but persistent inflation in 1983 and 1984 and thus the likelihood of a continued tight monetary policy over the period as well. This implies real interest rates that are higher than historical experience would suggest which, when combined with slow reductions in inflationary expectations, implies that liquidity premiums and nominal interest rates will also move down slowly over the period.

OFF-BUDGET BORROWING: TOTAL IMPACT ON CREDIT MARKETS

Question 4. Dr. Rivlin, I would like the Committee to focus on Table 10 on Page 32[1] of your report, which shows total off-budget borrowing, in addition to the deficit. Since we are all concerned about interest rates, it is this total impact we ought to be looking at, not just the official deficit.

Would you please summarize Table 10, and also tell us what the outlook is for 1983 and 1984?

Answer. The table indicates that, although the unified budget deficit is projected to be about $65 billion in fiscal year 1982, total Treasury borrowing from the public will be in the $80 to $90 billion range. This additional $20 billion in borrowing will be needed to fund the off-budget loan activity of the Federal Financing banks. The table also shows the estimated level of new loan guarantee commitments by the federal government to be $80 billion in fiscal year 1982. We have not yet projected the off-budget deficit or new loan guarantee commitments beyond 1982.

HOW CLOSE TO BALANCED BUDGET TO CALM CREDIT MARKETS

Question 5. Dr. Rivilin, I wonder just how close to a balanced budget we have to get to calm down the credit markets.

Let us take for a starting point CBO's estimates that starting today, we have to cut another $100 billion to achieve a balance in FY 1984. I am skeptical about whether we can get another $100 billion a year, plus the $20 billion in annual off-budget borrowing.

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[1] See p. 484.

How close to balance do we have to get? Will cutting the gap to $50 billion do the trick, or do we have to cut out three quarters, or what?

Answer. The response of credit markets to projected changes in the federal deficit is extremely difficult to quantify. In general, movements in interest rates reflect fluctations in the demand for credit relative to its supply; real growth, inflation, inflationary expectations and market uncertainties are important determinants of interest rates. The federal deficit is only one of several factors affecting these variables, and its estimated impact on interest rates depends in part on market perceptions about the response of the monetary authority to federal deficits, and the way in which price expectations are formed. Knowledge of these perceptions and expectations is not sufficient to provide confident estimates of the response of short- and long-run interest rates to federal deficit projections.

Despite concerns expressed by market analysis on Wall Street and abroad about the size of the budget deficit, there are different views regarding the impact of various deficit magnitudes on bond, stock, and foreign exchange markets. Recently, for example, one market analyst characterized a projected $65 billion deficit in fiscal year 1982 as "an inflationary situation," [1] while another said that "most foreign exchange traders won't know the difference between a $45 billion deficit and a $65 billion deficit." [2] With regard to achieving a balanced budget, and internal bank economist commented: "Even if you have a budget deficit of $30 billion in 1984, this isn't really a serious problem . . . . If it takes more time, that's no reason to lose confidence. . . . It's the long-term trend that's important." [3]

During the 1970's increases in the federal deficit were not always accompanied by a rise in interest rates, nor did reduced federal deficits always bring about lower interest rates. For example, in calendar year 1975—when the deficit rose by more than $65 billion—the interest rate on 3-mongh Treasury bills declined by 206 basis points. In contrast, the $10 billion and $15 billion reductions in the deficit during calendar years 1973 and 1979, respectively, were accompanied by increases of nearly 300 basis points in the 3-month Treasury bill rate. These statistics on contemperaneous movements in deficits and interest rates, however, may not be indicative of the current response of credit markets to estimates of the fiscal year 1984 deficit. Moreover, the relationship between interest rates and the deficit in 1982 may differ somewhat from that of the 1970s when most of the large deficits reflected the response of the budget to a weak economy. Finally, institutional changes affecting credit market instruments may be an important consideration in evaluating the link between interest rates and federal deficits.

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[1] *Wall Street Journal,* September 18, 1981.

[2] Ibid.

[3] Ibid.

VIEWS OF THE CHAIRMAN OF THE FEDERAL RESERVE BOARD

WEDNESDAY, SEPTEMBER 16, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 10:12 a.m., in room 6226, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman) presiding.

Present: Senators Domenici, Armstrong, Kassebaum, Andrews, Symms, Grassley, Quayle, Gorton, Hollings, Chiles, Biden, Johnston, Sasser, Hart, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

Chairman DOMENICI. The hearing will please come to order.

We are going to try to follow the same format as we have in the past. This is the arrival on the minority side. We will call on Senators based on arrival time, 5 minutes each, including opening statements, if you have any.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Volcker, it is a pleasure to have you here. You have been here before and before many committees of the Congress. It seems that you are always here at a time when the atmosphere is one of urgency and crisis. While I understand that there is somewhat of a similar atmosphere at this point, because of high-interest rates, I would hope that you would not have the kind of testimony today that you have had to give us before in that many of the economic indicators in this country are very positive and many predictors of the future are predicting a rather healthy economy.

We were privileged yesterday to have Dr. Rivlin up here. As you know, Chairman Volcker, she has, with her economic advisers, made their economic projections. They have very optimistic projections in every area except interest rates. You also know that compared with your last appearance before this committee, we now have had a number of months of rather healthy decline in inflation. I believe through June the inflation rate was about 8½ percent, with an upward lift following thereafter.

But, obviously, that is a good economic sign, and if Dr. Rivlin's economic advisers are right, we are in for a rather significant era of growth, in fact, almost twice the GNP growth for the next 3 years as we have had in the immediate past 3 years. Their projections and the administration's projections on growth, inflation, CPI, seem to me to leave the one remaining issue that is causing great concern here and in this country, and that is high-interest rates.

I want to say that I support the administration and your policy of moderately tight money. But I do have a number of questions and I am sure the Senators will have a number also. I do not take too seriously, Chairman Volcker, the expressions of jubilation or despair that rise up from the financial markets. I remember the "go-go" years of the sixties when everything was golden, stock prices would always and forever be up, and then I remember the gloom of the seventies when they thought that the bond and equity markets were about to collapse. In fact, in the past few years, it seems that the doom and gloom has dominated the economic markets. This has been an important signal to the policymakers for a radical change in policy. In fact, we have put some of that radical change into effect.

POLICY OF INTEREST RATE MANAGEMENT

But I must admit, Chairman Volcker, that I am perplexed at the consistently high level of interest rates in recent months. As I have indicated, we have had 6 months of slowing inflation yet interest rates are high. We have had weak economic growth since February, yet interest rates remain high. The money supply rises, interest rates remain high. The money supply declines, interest rates remain high. While I am not a student of monetary policy, at least not a diligent one, this appears to me to be interest rate management, Mr. Chairman, not monetary management.

If you look at the performance of the aggregates over the past several months, and I have your executive summary which you made in July, I hope you will bring us up to date. Your growth rate target for M_{1B} is 3½ to 6 percent for 1981, and I hope you correct me if that is not accurate. What has been the growth rate since July? Your target for M_2 is 6 to 9 percent. What has been the growth rate? Your target for M_3 was 6½ to 9½, and the growth rate in this aggregate has been at about 11½. Commercial bank credit growth has stayed within your ranges, and I think that is true.

So let me ask you, and I hope you will answer this in your statement—if not, that you will ad lib the answer to it—what is the effect of high-interest rates on the aggregate? Does not high-interest rates cause people to switch out of other investments and increase their holdings of such things as money market funds, and do not these types of shifts increase the growth in money supply aggregates, and what about the high-interest rate payments themselves? Do these interest payments not accumulate in the money market fund and other interest bearing accounts and raise the growth rates of the aggregates thus causing an inconsistency in what you have in mind for the aggregates?

Now, I understand and realize that these matters of money management are more of an art than a science. You have told me that privately on a number of occasions. But it seems to me that high-interest rates raise the money aggregates, not lower them.

So, as I indicated, I am not here to criticize the general policy but rather to question whether or not this art that you are attempting to perfect, whether or not it is inconsistent, whether or not some of the targets are meaningless when you have the inconsistencies that I just expressed. So unless we exercise caution, we will find ourselves in a catch-22 of monetary misunderstanding which, in the end, can only be damaging to our long-term plan for economic revitalization.

I look forward to hearing your comments on these matters, Chairman Volcker, and hope that you will supply the committee with some guidance on the specific actions that it can take to lower the interest rates. I believe you are prepared to address the issue of further fiscal restraint with some ideas as to which kinds of fiscal restraints would be most significant in terms of those who continue to be doubtful.

I yield to the distinguished ranking member, Senator Hollings.

OPENING STATEMENT OF SENATOR HOLLINGS

Senator HOLLINGS. Thank you, Mr. Chairman, and Chairman Volcker.

My understanding is that the Federal Reserve has two choices when you are faced with high Federal budget deficits. You can monetize the debt. That is, you can print money and, in essence, cause inflation. Or the other choice, of course, is to let interest rates remain high in order that the private market will buy that debt. And you are more or less going along with option 2 in light of the guaranteed Government in the red through Ronald Reagan's second term.

Now, I want you to address the subject in your remarks, please, the matter of revenues because every time you appear, particularly in the last few weeks, we hear Volcker urges more cuts to shrink the budget deficit. You and I both know that the President got the budget and tax cuts he asked for. And the program is working. That program guarantees deficits of $70, $80, and $100 billion in fiscal years 1982–84. As good businessmen, you and I vote no, there is not $100 billion in cuts. What that is, is a promise. Dr. Rivlin comes up and says in 1984 you can have a $50 billion deficit if you have $50 billion in further cuts that year. Suppose we make that. Is that going to affect the market? Absolute nonsense. We are not here to talk about promises. We have to develop a program that is dependable, reliable, and that people can invest upon.

I see from the business community all this talk about cuts. But is it not a fact that what is really causing the trouble is the extravagant and reckless revenue hemorrhaging that has been caused by this particular program? When you lose $93 billion in 1983 and $150 in 1984 and $199 in 1985 and $268 billion in 1986, you guarantee Government in the red for a long time. You are guaranteed that this Government will never get to a balanced budget. I think the business leadership and particularly the Federal Reserve should not go around parroting the same idea of further spending cuts, spending cuts, which everybody, including the market and the Federal Reserve, believes and knows is politically impossible. We are not going to cut social security and all these other programs. If we were going to—we would have to eliminate all the rest of Government to pick up $80 and $100 billion to get you back in the black.

So I think we ought to say—look at the revenue losses or whether we really need $12 billion as an incentive for oil in this day and time, whether we really need in 1983 a 10-percent individual income tax rather than a 5 percent. I go along with the business cuts but I do not see any reason to promise a 10-percent individual tax cut. If you are going to continue with a restrictive monetary policy, then there is no way the budget deficit can improve with the large tax cuts.

Chairman DOMENICI. We have Senator Grassley's prepared statement that we will insert into the record at this point.

PREPARED STATEMENT OF SENATOR GRASSLEY

Mr. Chairman, I am pleased that Chairman Volcker is with us this morning to discuss high interest rates and the Federal Reserve Board's monetary policy.

The Fed, in line with the Reagan economic plan, has attempted to bring money-supply growth in line with real economic growth.

In the short-run, interest rates have remained high because they are driven by inflation. Though inflation has declined in the past few months to less than 10 percent, the market has yet to be convinced that the Fed has abandoned its past practice of fine-tuning the economy with erratic monetary growth and contractions.

Though it is true that there are legitimate questions regarding the operations of the Federal Reserve relative to its policy goals, the entire burden of high interest rates cannot rest solely with the Federal Reserve Board. We must all work on a two-pronged solution that involves both the Federal Reserve and Congress. The Fed should eliminate some of the faulty tools it uses and focus on the monetary base. We, in turn, must work to reduce the government demand for funds in the private markets by lowering the deficit, reducing Federal credit activities, and promoting an increase in the rate of private savings.

This past July, I placed a statement on high interest rates in the Congressional Record. This statement fully discusses institutional reforms of the Federal Reserve that are necessary for the monetary stability we need to ensure our policy goals. I would like to make this part of the record for this hearing, and proceed to discussing the Fed's operations with Chairman Volcker.

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Congressional Record

PROCEEDINGS AND DEBATES OF THE 97th CONGRESS, FIRST SESSION

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Senate

HIGH INTEREST RATES

Mr. GRASSLEY. Mr. President, the recent economic summit conference in Canada covered a number of subjects, but none was so important as the continuation of high interest rate levels in the United States. All of us lament the mess we have gotten ourselves into, but it would be wrong to conclude from this that we have any easy way out.

The conventional wisdom is that high interest rates accompany the winding down of inflation. But we have to have noticed by this time that high inflation rates themselves beget high interest rates. There is no way we can have double-digit inflation and expect lenders to accept less than double-digit returns on their money. So it might be better to say that interest rates are not going to show really dramatic declines until inflation has already started down. That certainly seems to be what is happening now.

At this point, we seem to have very high real interest rates, that is, interest rates adjusted for inflation are very high. Economists in the administration confess themselves at least a little confused by the situation, and the records of meetings of the Federal Open Market Committee at the Federal Reserve reflect the same kind of groping for an explanation of what is happening.

Without making any claims to special knowledge or expertise, I want to offer a possible explanation that I do not think has been noticed yet.

I believe it is at least possible that the present high interest rates—especially when adjusted for inflation—are due to uncertainty in the money and bond markets over what direction the Federal Reserve will go in the future.

We are all aware that a stable, consistent monetary policy emphasizing gradual reductions in the rate of growth of the money supply is one of the four legs of President Reagan's economic recovery program. It is also the leg that is most nearly independent of the electoral tide that swept the country last November. So there can be a real question about whether the Federal Reserve will, in fact, go along with the President and the Congress in implementing its part of the economic program.

In the past, the Federal Reserve has certainly not been noted for its consistency. In October 1979, a great change in the Federal Reserve was announced, and it was claimed that thenceforth there would be much more emphasis on the rate at which money was created, and a closer hewing to announced targets. What actually happened was a wild swing in both interest rates and monetary growth. The Federal Reserve met its annual target a year later, but many experts thought it was a stroke of luck.

We know now that the Federal Reserve changed some things, but most importantly it left in place some of the operating tools that have contributed in the past to unstable policy results.

I am not going to go into a long academic discussion here, but I can report that it is the settled view of a large part of the economics profession that has studied the question that the lagged reserve accounting of the Federal Reserve makes it very difficult to have anything but very great short-term instability in money and interest rates.

In addition to the instability caused on a strictly functional level, because of purely technical considerations, the Federal Reserve has been guilty in the past of stop-and-go policy formulation. The Federal Reserve always seems to have one eye on inflation and the other on the gross national product. When prices are leaping upward, the Federal Reserve has decided to clamp down and the result has been a credit crunch and a recession. When business is bad, the Federal Reserve has started dumping reserves into the banks and after a while business does indeed pick up, but eventually those extra reserves means extra money in excess of production and so it means ultimately more inflation. And then the cycle starts over again.

The Federal Reserve has two eyes, but always seems blind in one of them, never having the perspective to understand that it—like so many others—has a poor ability to forecast the economy. Being unable to say where things are going, it is inherently unable to change policy to head off the business cycle. It cannot consciously and deliberately affect something that is hidden from it.

But this has never stopped the Federal Reserve from trying, and so we have gone from boom to bust to boom and so on and on. And as the Federal Reserve has contributed to instability instead of dampening it, the measures it tries to take are accordingly magnified, so the instability is accelerated.

The only answer to this vicious circle is to break out of it by resolutely refusing to chase the business cycle, acknowledging ignorance that can not be helped, and sticking to a stable and completely predictable set of policy actions that at least assure good long-term results. This is exactly what President Reagan has proposed, it is exactly what the Federal Reserve should do, but it is a complete reversal from the past and there is no assurance that the Federal Reserve will follow the suggestion with anything but lip service.

The result is that the policy instability of the past may well continue, in addition to technical instabilities. The money and bond markets can be excused if they think they have not had enough evidence yet of stability to bet on having it in the future.

The very fact that the Federal Reserve still refuses to take the relatively simple step of going back to contemporaneous reserve accounting and ending its dependence on an obviously flawed tool is probably taken as evidence by the market that the Federal Reserve really is not intent on mending its ways, and there is little reason to think that a stable monetary policy is forthcoming.

It is my suggestion that this expected instability is itself keeping interest rates up. So far as I can see, it is the one thing that can explain the extraordinarily high level of real interest rates that have already been adjusted for inflation rates. The markets are uncertain of what the Federal Reserve is going to do, and that uncertainty builds another premium into interest rates.

The solution to this problem is actually fairly straightforward, though the details are no doubt cumbersome to arrange. The Federal Reserve should rid itself of its faulty tools, in particular lagged reserve accounting, and it should announce in very concrete terms exactly what it is going to do at the Federal open market desk, aiming at a moderate growth in the monetary base that is the basis of all the money numbers and which is well within the ability of the Federal Reserve to control to a much closer tolerance than has actually been the case in the last decade.

I firmly believe that doing these two things would cause an immediate reduction in market interest rates though, of course, a much more substantial reduction will only come with actual continuing reductions in inflation. But it is at least something that can be done fairly quickly and with no cost other than reduction of bureaucratic make-work.

I think we have every right to expect action like this as a response to the country's expressed demand for a change of ways in Washington.

Chairman DOMENICI. Chairman Volcker, you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I am particularly pleased to be here today. It provides, first, an opportunity to congratulate this committee on its leadership in measures already adopted to begin the process of controlling the steeply rising trend of Federal spending. Looking ahead, I would like to consider with you the efforts that must continue to be made to restore sound, noninflationary growth to our economy, recognizing the relevance to that objective of healthy capital and money markets.

DISCONTENT FOCUSES ON HIGH INTEREST RATES

You are as aware as I of the difficulties in the current economic scene. Many individuals, businesses, and municipalities are facing substantial stresses and strains, and much of the discontent focuses on the persistence of extraordinarily high interest rates.

In this situation, we must not lose sight of the fundamental cause of our current predicament: The buildup of inflation and inflationary pressures over many years. A lasting resolution of our economic problems generally, and the interest rate problem in particular, will be found only in success in the battle against inflation. Should we be diverted from that objective, our economic and financial problems will only be aggravated.

The fact is we can now begin to see significant signs of progress in the fight on inflation. The various measures of prices this year have all shown somewhat slower rates of increase than in the preceding 2 years. While some sectors of the economy are indeed under heavy pressure, the overall level of economic activity is higher, and the rate of price increases lower, than almost all economic forecasters thought probable at the beginning of the year.

Under the circumstances, it may be frustrating to observe the skepticism and doubts reflected in the recent performance of many financial markets. I believe that skepticism will be proved unwarranted. But what is important in that connection is not my belief or yours, but whether we persevere in policies and actions to justify confidence.

RETREAT FROM OBJECTIVES WOULD AGGRAVATE PROBLEMS

The markets are reacting to the harsh reality of continuing inflationary momentum and heavy current and prospective financing demands. More broadly, they reflect the hopes and forebodings of millions of citizens about the future as they make investment decisions. The hard fact is that repeatedly in the past efforts to combat inflation, to curb deficits, and to limit monetary growth were not sustained over a long enough period to bring success. For all the signs of progress today, we need to recognize that, in some respects, the toughest part of the job remains ahead. We also need to recognize there is no safe, painless alternative to the fiscal and monetary objectives we have set for ourselves; indeed, a sense of retreat would not only aggravate the present problems, but could set back the prospects for restoring growth and stability for years to come.

In the area of monetary policy, I think we are all now generally agreed that inflation will not be brought under control without persistent restraint on growth in money and credit. History provides ample evidence that inflation will not subside, and price stability be maintained, without confining the longer term trend growth of money and credit to amounts consistent with the growth of output. The Federal Reserve has stated its intention to pursue such a policy of restraint. As I reported to the Congress in July, we are reasonably on track currently in achieving our reduced money supply objectives this year. We also recognize, in the years ahead, growth in money and credit will need to be further reduced.

In a situation of inflationary momentum and rising costs, monetary restraint, however necessary, is not an easy process. I must also quickly point out the alternative of trying to accommodate the provision of money to inflationary demands could only be more painful over time. We have learned the hard fact that we cannot live comfortably with inflation, that it only undermines our growth potential, and that it will inevitably bring higher, not lower, interests rates.

What we as a government can do is to relieve the pressures on the credit markets, on monetary policy, and on the economy growing out of our fiscal imbalance. As you are well aware, the administration and the Congress have taken very large steps, in a remarkably brief period of time, to stabilize and reduce the Federal tax take relative to national income. Indeed, as a percent of GNP, revenues should fall be over 2 percent by 1984, reversing the climb to a postwar peak of over 21 percent in recent years. Looked at in isolation, the new tax law offers the prospect over time of improving the environment for business and personal savings and investment. Investment incentives should be strengthened by the capital cost recovery provisions; the lowering of top bracket marginal tax rates and the accompanying reduction of capital gains taxes should help to increase the availability of venture capital; and incentives for productive activities—for saving, working, and risk-taking—should all be enhanced.

TAX CHANGES INVOLVE LOSS OF REVENUE

But we cannot escape the fact that tax changes also involve a large loss of revenue in the years immediately ahead; receipts will be about $80 billion less in 1984 than at the existing GNP-tax ratio, and about $150 billion lower than the preexisting tax rates would have produced at the same level of income. There are, of course, two sides of the budgetary equation, and we start from a position of a large deficit. Without spending restraint in place alongside tax reduction, the Federal Government will continue to preempt a large fraction of one of our scarcest resources—savings. Then, the most credit-dependent sectors of the economy would inevitably remain particularly vulnerable, just as they are today, in effect left with the crumbs from the national economic table. And even businesses directly benefiting from tax reduction and new incentives will find themselves in strong competition with the Government for available savings, blunting the very objectives sought.

The problem—which, of course, manifests itself in exceptionally high interest rates—will not, and can not, be solved by inflationary money and credit creation by the Federal Reserve. The net result of that would be to incite further borrowing and ultimately damage savings as well. Nor can a "solution" be found by trying to ration scarce credit and savings by some arbitrary and ultimately unenforceable system of credit controls; indeed, efforts by borrowers to protect themselves and consequent market disruptions would likely only make the situation worse.

What can be done—and done consistent with our short and longer-run objectives—is to provide assurance that the Federal fiscal position is indeed clearly on the track toward balance. On the spending side of the fiscal equation, the Congress and the administration have begun an effort unprecedented in my Washington experience to scale back the growth of Federal outlays. At the same time, it is evident that, given the size of the tax reduction, the spending cuts made so far—large as they may be in historical perspective—have been only a "downpayment" on those needed to bring expenditures into alinement with the receipts side of the budget. The administration budget estimates presented to the Congress during the debate on the tax bill always assumed a large amount of as yet unspecified cuts for the fiscal years ahead. Those estimates have themselves been based on relatively optimistic economic assumptions. As I understand it, in voting tax reductions by large majorities, the Congress accepted the challenge of cutting the spending suit to fit the revenue cloth.

BUDGET IN DEFICIT 20 OF PAST 21 YEARS

Failure to carry through on efforts to slow the growth of Federal expenditures in amounts commensurate with the need would leave us with the reality and prospect of large deficits in relation to our savings potential, with its inevitable implications for financial markets and for sectors of the economy dependent on credit. The harsh fact is that the past track record has not been encouraging; the Federal budget has been in deficit in all but one of the past 21 years. More often than not, deficit forecasts have been successively enlarged with each new estimate. It is doubts arising out of this experience that, it seems to me, lie behind much of the market skepticism.

More generally, our patience has been tried by efforts to deal with inflation, and past efforts have been relaxed prematurely. Doubts that inflation will be brought under control continue to act perversely as an incentive to borrow; for their part, lenders remain reluctant and want to protect themselves against the prospect of declines in the real value of their assets. Thus, even in conditions in which the economy as a whole is sluggish at best, we have had strong inflation-generated demands for credit pressing against constrained supplies, which only serves to push up interest rates.

Aside from these expectational effects, the direct impact of budget deficits on the market seems to me evident in the data. Net of capital consumption allowances—that is, the amount necessary to maintain the present stock of business investment and housing—we generated about 170 billion of savings last year, reflected largely in business retained earnings, personal savings, and State and local pension fund contributions. That is what we have at current levels of income to add to our plant and equipment, to inventory, to housing—and to finance the Federal Government deficit. As shown on table 1, the financing required by the combined unified deficit and off-budget Federal financing totaled over $80 billion, nearly one-half of the total available.

TABLE 1.—SOURCES OF SAVING IN THE UNITED STATES

[National income and product accounts basis]

	1975–79		1980	
	Billions of dollars	Percent of GNP	Billions of dollars	Percent of GNP
Gross national saving [1]	353.3	18.1	457.2	17.4
Capital consumption	201.0	10.3	287.2	10.9
Net national saving [1]	152.3	7.8	169.9	6.5
Personal	82.7	4.2	101.3	3.9
Corporate	47.0	2.4	44.3	1.7
Other	22.6	1.2	24.3	.9
Memo: Federal Government deficit [2] (unified plus offbudget)	−60.9	−3.1	−83.3	−3.2

[1] NIPA gross saving excluding NIPA Federal surplus (or deficit) plus net foreign investment (sign reversed).

[2] The Federal deficit on an NIPA basis averaged $42,6 billion in 1975–79, 2.2 percent of GNP, and was $61.2 billion in 1980, 2.3 percent of GNP. The offbudget deficit, alone, averaged $9.7 billion in 1975–79, and was $15.4 billion in 1980.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts. All rates are calculated as the average value of item for the period, divided by the average value of GNP. Details may not add to totals because of rounding.

The point is often made that, relative to our GNP, our budget deficits are relatively small by international standards. So they are. But so are our savings, and it is the relation between the two that counts. (See table 2.)

TABLE 2.—INTERNATIONAL COMPARISONS OF SAVING—U.N. SYSTEM OF NATIONAL ACCOUNTS BASIS

[Percent of gross domestic product]

	1975–79 average	
	Gross saving	Net saving[1]
Canada	20.8	10.1
Japan	32.0	19.0
France	22.8	11.6
Italy	22.2	12.2
Germany	23.0	11.8
United Kingdom	18.0	6.8
United States	17.2	4.9

[1] Gross saving less capital consumption allowances.

Source: Organization for Economic Cooperation and Development, "National Accounts of OECD Countries, 1962–1979" (Volume II). All country data are reported according to the United Nations System of National Accounts, which differ from the United States NIPA. Details may not sum to totals because of rounding.

I would quickly add that the effect of a deficit on the economy and capital markets can only be judged in the context of a particular economic situation. There may be relatively little risk of crowding out in a period of high actual or potential savings, falling investment demands, adequate homebuilding relative to demands, and low interest rates. But that is surely not the circumstances of today, in which we have a clash in the market among competing demands.

FIRMS AND INDIVIDUALS UNDER INTENSE FINANCIAL PRESSURE

The essence of my comments today is simple. There are intense financial pressures on many firms and individuals. We would all like to see relief from those pressures as soon as possible. We don't want them to recur. Ultimately, that is dependent on dealing with inflation—and policies that do not recognize that reality can only prolong the pain, whatever their surface appeal.

Dealing with inflation, in turn, requires restraint on money and credit growth. Entirely consistent with such restraint, reduction in Federal deficits—and the perception that those reductions will be continued until balance is reached—will greatly help to relieve market pressures and to make room for the investment and housing we want.

I can appreciate the irony, from your point of view and mine, of some recent financial market developments. Amid encouraging signs of progress on inflation, with your strong efforts toward expenditure control, with firm monetary restraint in place, the markets seem to be expressing doubts. But after all, Americans have not seen for many years a successful fight on inflation or balanced budgets or so massive a tax reduction. A lot of bets on the future are still being hedged against the possibility that you, and we, will not carry through.

We have been at critical junctures before in the fight on inflation—and the bleak reality is we have not had the foresight and the courage to stay the course. That is why we have gradually come into the grip of the most prolonged and debilitating inflation in our entire economic history. The lesson is clear—we must carry forward on the basic fiscal and monetary course upon which we have embarked. To do less would not only throw aside the signs of progress we are seeing, it would inevitably make even more difficult an attack on inflation in the future, with all that would imply for our economy and our society.

We mean to do our part, and I am sure we can count on this committee to carry on the effort it has so well started.

Chairman DOMENICI. Thank you, Chairman Volcker. I have just three questions and I will yield.

In the past few days, The Federal fund rate and interest rates for short-term Treasury bills have dropped sharply, 3 percent on the Federal fund rate, 1 percent in 1 week on the short-term Treasury bills.

Are these signs that the Fed is easing the money supply?

MONEY SUPPLY RELATIVELY QUIESCENT

Mr. VOLCKER. These are not signs of our easing money supply in terms of our basic objectives and policies. These are more a reflection of the fact, to some extent, that the money supply has been relatively quiescent—in line with our objectives. By-and-large, there is no strong pressure on the money supply. We face the situation, to answer your earlier question, where the narrowest measure in the money supply—M_1, transactions balances—has actually been running low relative to our targets; but at the same time, as you pointed out, M_2 is running slightly above the latest figure—just a shade—basically at the upper end of our target range; and if we look at the broader measures of credit and money, as encompassed in M_3, we are running above the upper end of the range. So we have somewhat of a mixed picture, depending on which target you look at and, of course, we have to evaluate the particular reasons why particular aggregates may be moving differently than expected.

My overall judgment, as I said in the statement, is that we are reasonably on target with respect to our objectives for money and credit growth. I certainly keep an eye on those broader aggregates that are running somewhat high and on that narrower aggregate that is running a little low, but looking at the whole picture, I am reasonably satisfied.

Chairman DOMENICI. Chairman Volcker, are those indicators that I gave you that are current, do they mean that interest rates are coming down?

Mr. VOLCKER. We have a situation, interestingly enough, where, as you pointed out, since Congress acted on the tax bill, short-term rates are down significantly: the most sensitive short-term rates are down; the long-term rates are not.

With long-term rates, we get into not only immediate market factors but also appraisals of the future and of economic conditions. When you ask the question about interest rates, you have to realize that the market is making an appraisal every day not only of what is happening in terms of the provision of bank reserves and the money supply this week or next week or next month or over the past month, but also of what the future will bring. I think the outlook for interest rates is going to be determined fundamentally by a market judgment as to how successful we are going to be and how successful you are going to be and how successful the administration is going to be in the complex of monetary and fiscal measures designed to attack inflation. If there is no confidence in that outlook, and our programs are not convincing, the interest rate outlook will not be favorable. If we are convincing, then I think it will be favorable, and it is our job to be convincing.

INFLATION IS DOWN

Chairman DOMENICI. Well, Chairman Volcker, inflation is down substantially, is it not?

Mr. VOLCKER. I would not use the adjective "substantially;" it is down.

Chairman DOMENICI. How much is substantial?

Mr. VOLCKER. The Consumer Price Index, as we have discussed in the past, is subject to a lot of distortions in the short run. We probably had an abnormally high reading last year. We had some good fortune through some of the effects of monetary restraint in the early part of this year. Then we had a bad figure in July, as you noted. The wholesale price index, the producer price index, has been behaving quite well in recent months.

I would say we have moved the inflation rate down perhaps 1 or 2 percent. We have to add another indicator, wage rates, which is rather fundamental to the outlook for inflation because wages are about two-thirds of all business costs. If we are going to make fundamental, sustained progress on the inflationary front, we have got to see those wage settlements beginning to come down. The evidence so far has been very mixed. If you look at one series you see signs of progress, but if you look at another series you get a little discouraged. Looking at this indicator of cost pressures and therefore underlying inflationary pressures, I think you have to come to the conclusion, that it is, at the very least, far too early to claim victory. We just do not see the kind of movement in those figures as yet that is convincing in terms of a sustained, continuing decline in the inflation rate; that is yet to come. Until we see that, then I think we have to call the progress that has so far been made on inflation still tentative.

Chairman DOMENICI. My last question on this first round, Chairman Volcker, if I read you correctly, you say the signs are good. We have taken the first step. That first step is a good first step. But that there is such a long history of not following through that you assess the lack of confidence on that.

COMPLEMENTARY SPENDING RESTRAINT MISSING

Mr. VOLCKER. That is indeed a major element. In terms of the steps that are being taken, we can think of financial policy as a kind of three-legged stool. One leg is reduction in taxes; another is firm monetary restraints in place; the third leg of the stool, I have to say—the complementary spending restraint necessary with the tax program—is not in place. The present reality is that the third leg of the stool is not firmly there yet.

Chairman DOMENICI. Mr. Volcker, do you believe that, as suggested by the distinguished minority member, and I am sure he will followup with his own specific points, but do you believe that this lack of confidence is because the tax cut measures are too big or would there be a response if our President was to suggest a credible way of cutting the $30 billion and $44 billion that were unidentified that was believable, and people believed it could happen?

Mr. VOLCKER. Yes; I think that is what people are looking for. When you say $30 or $44 billion——

Chairman DOMENICI. I am using the unidentified cuts.

Mr. VOLCKER. I understand. There was that line in the administration's projections for "savings yet to be announced"—I think was the term that was used. I would have to point out to you that those budgetary assumptions also assume savings from social security initiatives which have not yet been acted upon and from another line, "savings yet to be accomplished," identified somewhat more specifically but have not yet been acted upon. When you consider all those elements not yet acted upon, as well as the $44 billion that is not yet identified, using the administration's own numbers, you come up with a figure fiscal 1984, of $83 billion that the Congress has not yet acted upon and a part of which, more than half of which, the administration has not yet identified.

Mrs. Rivlin presented some estimates before the committee yesterday which I have had a chance to review at least briefly. She noted some $40 billion. She projected—based upon reasonably optimistic projections, as you suggested—a deficit of $50 billion in 1984. Therefore, if you state the objective as balance in 1984, I have to offer you the broad judgment that, in terms of actions of all sorts yet to be taken by that fiscal year, which is 3 years off, you are talking in round numbers of $100 billion.

START PROGRAMS NOW TO REACH 1984 OBJECTIVES

Senator HOLLINGS. Are we going to have to wait until 1984?

Mr. VOLCKER. You cannot wait until 1984, in my opinion, to get started on this effort. You are not going to make the objective in 1984 unless you start now.

Senator HOLLINGS. And what should we have, some kind of action by this fall, before we adjourn?

Mr. VOLCKER. Well, of course, you——

Senator HOLLINGS. To get these interest rates down. That is what we are all working on.

Mr. VOLCKER. The more you can do on the budgetary situation, the better. You have to face the 1982 problem immediately, obviously——

Senator HOLLINGS. And the 1984 problem immediately.

Mr. VOLCKER. I think what you do now has consequences for 1984, and so in working on 1982, I think it is very important that you consider and start programs now that may have a limited effect in 1982 but are essential to the 1984 objective; and that is what everyone will be looking at to assess how realistic the program is.

Senator Hollings. In trying to obtain that objective, does the Federal Reserve or the financial community really care whether it is that much less in spending cuts or that much less in tax cuts?

Mr. Volcker. All things equal, I think many members of the financial community would say that if you can do the spending cuts and have the tax reduction, you will have the best of all worlds; that is, from an economic standpoint, the best results in terms of economic incentives and economic growth, will come from achieving both.

Senator Hollings. But the size of the tax cuts—you touched on that in your statement. If the size is too big, in other words, you just stated, $50 billion deficit really to get to a balance you are looking for $100 billion—have you got some idea where we can get $100 billion?

Mr. Volcker. I think that is the task you have left for yourselves in acting on the tax cut. If you tell me you cannot do it, then you have to look somewhere else.

Senator Hollings. You better be sober on that. As I understand it, in voting tax reductions, by a large majority, the Congress accepted the challenge of cutting the spending to fit the revenue cloth. That is a cute political statement. But the very author of that, Mr. Jack Kemp, said he is going to achieve it by going to the gold standard. He is not for any more spending cuts. I do not know where you get the statement.

Mr. Volcker. That is not my understanding of the administration's position or indeed of the congressional position in enacting the tax cuts.

WITHOUT SPENDING CUTS ADDITIONAL REVENUES WILL BE NEEDED

Senator Hollings. Seriously, what would be wrong, rather than having across-the-board individual income tax cuts, guaranteed business cuts, go to individual income tax cuts and rather than 5-10-10 at this time, just say 5-5 and 5 guaranteeing the revenue, cutting back on the deficit, cutting back in the $12 billion for oil—you do not think oil needs $12 billion, do you?

Mr. Volcker. One of the things I am not responsible for is allocating the tax cut or the expenditure cut. I face the fact that Congress, a month, ago passed this tax bill. They had a reason for doing so. If you tell me now that you do not accept what I see as the spending corollary to that action, I can understand why you need to search for additional revenues; I think that is where you are left, ultimately, if you do not get the spending cuts. But, having acted on the tax bill a month ago, I would feel the first line of action is to carry out the spending implications of that action.

I would agree that if that is impossible—if you tell me you are never going to have a balanced budget and the implication is that with this revenue base the Federal Government is going to continue to divert a disproportionate amount of the very small savings in this country into Government expenditures rather than into housing or into business investment—then at some point, although I would not think it is now, you will have to begin thinking about how to raise revenues.

Senator Hollings. Thank you, Mr. Volcker.

Chairman Domenici. Senator Armstrong?

Senator ARMSTRONG. Thank you, Mr. Chairman.

PRESENT LEVELS OF INTEREST RATES BRING ABOUT HUMAN TRAGEDIES

Chairman Volcker, there is a story about the caliph of Baghdad which disguised himself in the garb of a peasant to go out and move among the people of Baghdad and see what they are really thinking. I commend this story to you because I am sure you are perhaps more familiar than any man in the country with the statistical phenomena associated with the high interest rates. I assume it must be very difficult for you to really get first-hand opinions of how it affects people in their every day lives. I just want to emphasize that what we are talking about is the human tragedy of very great importance, with the interest rates at the present levels they are soaring to. It means families doubling up in housing. It means young people do not get to go to college. It means businesses are shutting down, people are thrown out of work, families break up. It is a matter of the utmost seriousness.

I do not say that to you because you never indicated you regard it lightly but simply because I think it is important that this body focus on the human as well as the statistical aspect.

Mr. VOLCKER. May I just interject a comment, Senator, because I think your remarks are appropriate. I think we must have some first-hand awareness of those problems in order to do what is basically necessary to deal with them and so that they do not get worse. I get a lot of mail, and I have been around this country a little in the last month. I also took a brief trip to Brazil a week or so ago, a country that has many of the same problems that we do, only much more severe, and that had not dealt with them over a number of years. Of course, you have to add a few zeros to our interest rate and to our inflation rate to match their situation, but I think we face similar problems. We want to deal with those human problems, but we have got to solve them and not just put a band aid on them or we will end up in a worse situation.

FEDERAL RESERVE'S IMPACT ON INTEREST RATES LIMITED

Senator ARMSTRONG. Mr. Chairman, I commend you for your statesmanship in this manner. But the reason I wanted to share with you at least in passing the depth of the human problem we are coping with here is because there is a perception which is astonishingly widespread, at least in the constituency that I serve, that if you wish to do so, that you could really lower the interest rate. Now, I am oversimplifying it. But the perspective which I hear, not just from the hoi-polloi but supposedly sophisticated observers, the passing scene comes down to this, that every morning Paul Volcker gets up and decides what the interest rate should be and adjusts it accordingly.

There is a bit of laughter in the room but I am talking about what businessmen think and even some bankers that have expressed that idea. Before you respond, let me just add this, because in my view this is a crucial issue before this committee and before the Senate. I have never believed that to be the case. I have been under the impression that the actual impact which you and your colleagues on the Reserve Board can have on those interest rates is quite limited, that in fact far from being able to decide this afternoon that the interest rates ought to be 15 percent or 12 percent, that you are rather tightly constrained by factors which are more or less beyond your control. If that is not true, if there is something which you could unilaterally do to bring down those interest rates, then I would like to know about that and I think the committee would. If it is true that you are constrained, then I think that it is important for us to bring that to the attention of the public.

Mr. VOLCKER. You are, of course, right in your feeling that we are constrained and restrained. People comment to you that the Fed can wake up in the morning and decide what interest rates should be that morning. Let me carry the implied question one step further and explain what we can do. What we basically can do is either provide reserves or not provide reserves; that we can do each morning. But should we provide more reserves or less reserves, and what would the effect be in terms of interest rates? Should we increase the money supply or decrease the money supply? If we had no objective in the world other than to get interest rates down by Christmas, what would be the way to go about it? I think you will see that the answer to that question is not very clear, to say the least. If we said we would pump up the money supply, I think the chances are very high that interest rates would be higher.

REDUCING BORROWING RATES NO. 1 ECONOMIC PRIORITY

Senator ARMSTRONG. I think you are right. I just want to ask one other question. If in fact the Federal Reserve Board cannot unilaterally bring those interest rates down, and I think every member around this table would agree that reducing the borrowing rate for business and private lenders is the No. 1 economic priority, if you cannot do it on your own, can you suggest any scenario at this time by which interest rates can be reduced unless the budget deficits are markedly reduced and unless the credit markets are persuaded that they will be reduced in the future? You have testified that it is your best judgment that we have got to reduce the deficits and we have to convince Wall Street, by which I do not mean literally the street in New York but the lenders and people who invest in this country, on Main Street as well as Wall Street. But short of that, is there any other credible scenario that you are aware of by which this interest rate problem can be solved?

Is it possible to bring down interest rates without getting those deficits under control?

Mr. VOLCKER. I think that has to be part of the process. There are a lot of other things that bear on the inflation outlook, and therefore on interest rates. You are not going to get interest rates down, and you are not going to keep interest rates down, unless people have a sense of progress on inflation, so, in the broadest sense, any policies that move in that direction in a convincing way are helpful. I am not arguing that there is anything drastic you could do in the next month that would change that importantly. But what I do have in mind, what I want to keep in your mind, is the relevance of all the policies that the Government follows with respect to regulations that add to cost or inhibit competition and the lowering of prices in the marketplace; these policies are all relevant ultimately to the interest rate question.

BALANCED APPROACH NEEDED

Senator **Armstrong**. If we solved those questions, but neglected to make progress on the deficits, would interest rates come down?

Mr. **Volcker**. In practice, you have got to work on that fiscal side. The point is sometimes made that you can reduce inflation with monetary policy alone, that we can squeeze hard enough and long enough to get inflation out of the economy whatever else is going on, whatever the fiscal deficits and so on. That is nice in the textbooks, but it is not going to happen that way in practice. I think you know and we know that course of action implies an intensity of pressure on monetary policy, an intensity of pressure on financial markets; if the Government continues to swallow up so much of the available savings of which there is so little, there will be so much pressure on the financial markets that this is, at the very least, a very high risk policy, regardless of whether it might ultimately be possible in some theoretical sense.

The way to deal with this situation, without question, is to have a more balanced approach, to lighten the fiscal load. That will bring the economic, financial, and, eventually, interest rate impact that you want without the enormous risk that comes from leaning on monetary policy alone and all that that implies in the short term as to pressures on the financial markets.

Senator **Armstrong**. The chairman has advised me that my time has expired, and I just wanted to say that there are a lot of us eager and enthusiastic in backing what you are doing, even though it is not entirely popular or pleasant.

Mr. **Volcker**. Thank you.

Chairman **Domenici**. Senator Hart?

Senator **Hart**. Well, Mr. Chairman, this town, when it gets in trouble, starts looking for a villain, and right now it is popular to beat up on Paul Volcker. I think my colleague from Colorado has highlighted that. But to paraphrase Shakespeare, I suppose the fault is really among ourselves for an administration that claimed to be promoting sacrifice and restraint.

It really has created a record in 8 or 9 months of existence of promising people that they can have everything, can have massive tax cuts, and have increased defense spending, can balance the budget, and we can have a reasonable interest rate, and clearly we cannot do all of those things.

IS $100 BILLION ADDITIONAL BUDGET CUTS REALISTIC?

Mr. Volcker, how realistic do you think it is to expect Congress to cut the budget $100 billion more?

Mr. **Volcker**. I guess I have to say that that is a question for you to answer and not for me.

Senator **Hart**. You have no opinion on the reality——

Mr. **Volcker**. I am well aware of the arithmetic: you have defense rising, you have so-called entitlement programs taking a very big chunk of the budget and basically indexed, and you have more and more people become entitled to the entitlements so those budgets tend to rise faster than inflation and faster than the economy. You are faced with what I know is an excruciatingly difficult problem. You have got to cut defense or you are going to cut entitlements, or both.

Senator HART. The President is in the paper this morning saying he is not going to cut social security. He has made what Wall Street has already regarded as laughable suggestions for reducing the increases in defense spending, and I think clearly in the early, that is to say, August effort to identify the unidentified $75 and $100 billion in additional cuts, the administration is not even close, and the Congress is not even close, and it is not going to be close.

If indeed that turned out to be the case, if I could demonstrate to you today that we are not going to cut $100 billion from the budget, would you then believe it would be reasonable for this Congress to reverse a decision made in August, and defer, defer the personal tax cuts to guarantee a balanced budget as early as 1983, and therefore send the same kind of fiscal, responsible message to the markets that they need?

Mr. VOLCKER. If it is demonstrated that the Congress cannot reach the spending objectives, a point that I am not ready to concede, as I said earlier, I think the implication is that you will have to look for new revenue sources. That does not say you have to rescind what you have just done in terms of personal income taxes; there are other avenues that could be looked at.

There are aspects of the tax structure, for instance, that many other people and I have pointed out remain, in terms of our general economic objectives, a bit punishing to savings and investment. Some changes there could be made in a way that raises revenues. There has been discussion from time to time about our energy problem; there may be revenue raising measures in that area which would not be inconsistent with the energy conservation effort.

So you can raise revenues without repealing what you have just enacted.

DEFER PERSONAL TAX CUTS

Senator HART. I will just tell you, as a practicing politician, there is one thing that is less likely to happen than cutting spending by $100 billion, and that is increasing taxes. That leaves the only option deferral of personal tax cuts. This Congress is not going to pass major new tax increases. It ought to, probably should, ought to tax, ought to put a tariff on imported oil, ought to do a lot of things. We had 11 votes in the last Congress for a 10-cent-a-gallon increase on gasoline. It is not going to happen. It will equally not happen that we are going to cut $100 billion, as it is equally not going to happen that we are going to increase taxes.

The only option, if we are going to send the signals to the market, is to defer the personal tax cuts, admit it did not work, put it off until we get the budget in balance, which we could do by 1984, and then give the tax cuts. I think that would be a reasonable approach.

You said in your statement that we have made this decision on taxes, and therefore we have no choice but to go after the spending side. I think what happened was that the Congress went along with the administration, and tried to do two different things that were contradictory, what you say, reduce the Federal tax and balance the budget. It just cannot be done.

If you have any further comments or thoughts on that, it would be appreciated.

Mr. **Volcker**. I do not have any further comments. I do interpret what happened as, in effect, heightening the challenge of working on the expenditure side at this point. I would not prejudge that issue.

Senator **Hart**. There is nobody in Congress, to conclude my questioning, that is more opposed to high interest rates, tight money policy, than I. But I do not blame you for this situation. I think it is going to be terribly wrong for Members of Congress, particularly those who supported the tax cuts, now to try to take it out on the Federal Reserve Board, because that is not only not fair, I think it is not particularly politically courageous.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you, Senator Hart.

Senator Kassebaum?

Senator **Kassebaum**. Mr. Chairman, I have been surprised that so many Members of Congress that have come back from the August recess and have just discovered the concern throughout the country about high interest rates, because it has been something that has been building for quite sometime. I think part of the problem has been the expectation that new budget and tax policies would produce an immediate turnaround. That has not happened.

With our frustration it is easy for the pot to call the kettle black, as we try and understand how we can get the economy under control.

I have been a great admirer of yours and of your leadership. I am very respective of an independent Federal Reserve. I think it is easy to demagogue this issue from a legislative point of view.

MARKET RATES AND DISCOUNT RATE NOT CLOSELY TIED

I would like to ask you about two things that are, I am sure, as frustrating to you as they are to us. One is regarding the relationship of the discount rate to the Fed fund rate. In April the Federal Reserve Board raised the discount rate, after a spurt in the money supply, and this immediately caused a reaction in the marketplace, and reflected a negative position.

On July 20, I think, the Fed fund rate was about 20 percent, and today it is about 16 percent, 15¾. That is a drop of 340 bases points, and yet the discount rate has remained the same.

The tightening down in April was appropriate, but why have you not again decreased the discount rate?

Mr. **Volcker**. I think the figures that you review suggest what is the fact of the matter, that the market rates are not very closely tied to the discount rate. We have had a significant decline in short-term rates in the past couple of months. Earlier, the markets were quite high relative to the surcharge on the discount rate, but I think it is fair to say that the market rates are right at the moment, in the last few days, have been rather low relative to the surcharge on the discount rate, not to the basic discount rate. We tend, over a period of time, to keep those rates in some alinement, so that is a matter—you can expect us to review from time to time.

Senator KASSEBAUM. Have any of the Federal Reserve Banks requested that the discount rate be decreased?

Mr. VOLCKER. I would prefer not to get into that particular matter. That is not information we ordinarily talk about publicly.

Senator KASSEBAUM. But didn't a recent change in procedure provide for more flexibility in policy there?

Mr. VOLCKER. We found that that was not as possible or desirable as we thought. As you know, the discount rate has not been changed very much, but that is a matter which is relevant to consider in the light of recent market developments. I do not deny that.

PRIME RATE AND DISCOUNT RATE NOT RELATED

Senator KASSEBAUM. How can a bank lower their prime if the discount rate does not come down?

Mr. VOLCKER. They have just lowered their prime a little bit, but they have often raised the prime when the discount rate has not changed. Banks tend to relate the prime rate not to the discount rate, but to their cost of money, as reflected particularly in the rates they pay on certificates of deposits, which now is probably a percent and a half or more below its peak level; and it is that kind of a development that puts downward pressure on the prime rates. In fact, those money market rates are a little low relative to the prime rate now.

Senator KASSEBAUM. I would like to ask one other quick question before my time runs out. The figures again, and it was touched on before, your target projection on M_{1B} being approximately 7 percent, and it is about half that now, is that not right?

Mr. VOLCKER. It depends on which M_{1B} number you look at. These figures get a little complicated. We tend to look at the number that is adjusted for shifts in the NOW accounts. The latest statement of the target was about 3½ percent, and we are running about 1 or 2 percent. We know some of the reasons why that is running low, including the shift of funds into the money market funds. The other aggregates are high. In a sense, we could stand some increases in M_{1B} certainly in relation to our target, but, looking at the aggregates together, we do not want to increase M_{1B} at the expense of excessive growth in other measures of aggregates.

Senator KASSEBAUM. Do you attribute the shift in money market mutual funds as one of the reasons?

Mr. VOLCKER. One of the reasons is because the money market mutual funds, in part, act as a substitute for NOW accounts or demand balances, and that shift—the increase in money market funds—has been very large this year. I think there is no question that that is the reason why M_1 has been running low relative to other aggregates. It is also the reason why M_2 has been running high; and that is an exceptionally rapid increase in that component.

Senator KASSEBAUM. My time has run out, thank you.

Chairman DOMENICI. Thank you, Senator Kassebaum.

Senator Riegle?

HIGH INTEREST RATES WORSE FOR SOME THAN OTHERS

Senator RIEGLE. A comment first and then a question.

With respect to high interest rates, I think what is often lost is the fact that as miserable as they are on the economy, they are far worse for some than others. As I look across my State or the Nation, I see some people that can ride out the high rates and other people that are just being literally torn to pieces by them.

I think there is a legitimate question here, even for someone who puts forward the argument that you put forward today, that after a period of high interest rates, the damage that is done to some sectors is so severe and so—the damage more severe than is felt by other sectors, that you really have to take account of that problem and you may have to find some way to make an adjustment.

So people talk about credit controls. You do not like that idea. There are a number of other things that might be considered.

I don't want to stress the fact today that there are some people that will not survive and are not surviving this kind of credit crunch where there are others who can ride it out really very nicely.

Mr. **Volcker**. May I interject a brief comment?

I fear that you are exactly right on your point, that this hits very unevenly, which is one of the major problems. We have said—and are, of course, holding the position—that we cannot solve that problem by easing up generally. Nor do I think credit controls are the answer.

That is precisely the kind of problem which, in effect, can be dealt with through the fiscal side. When less money is taken out of the financial market by the Federal Government, there will be less pressure on that market. Of course it is not easy to reduce Government spending or to increase taxes. But that is a mechanism, and a fundamentally important method, of spreading the burden so it does not just hit on those people who happen to be dependent on the credit market; as you rightly point out, they are affected particularly severely.

Senator **Riegle**. I had a situation the other day where a group of people were in from my State of Michigan and I have a farmer talking with me, a man probably in his late fifties, and probably as conservative a man as you can find in terms of how careful he is with his work and his profession, and he was talking about what the high interest rates are doing to him, and burdening him in ways that he feels he will not be able to survive literally and keep intact his farming operation.

As he was talking to me, he just burst right into tears. That is how severe the strain is on people emotionally as well as just the hard facts.

SPREAD SACRIFICES AROUND

I think you will have to do something to deal with that part of the problem. I do not think it is sufficient, you may want to respond or not, but I am saying I do not think it is sufficient to merely say that you have got to keep the restraint that tight that long, that a large part of the economy or various sectors of the economy just has to go ahead and take the maybe double or triple size burden that happens to hit them.

I do not think that is a workable strategy. I do not think it is a fair one and if we have got to create a new mechanism to deal with what everyone describes as a new problem, then maybe that is our next task, to do that, so we even this thing out and spread the sacrifice around, so it is in bearable doses.

Mr. VOLCKER. I certainly would like to see it spread around. But our basic dilemma, to repeat myself, is that if, in an effort to deal with this immediate problem—which is very severe for some people—we inadvertently worsen the inflationary situation, we are inevitably going to have these problems repeated on a more severe scale.

If I might make one other point. Without denying your point, that the impact is uneven, I think in this situation we have to be cautious about blaming all, the difficulties that some sectors of the economy face on interest rates; in some cases where a major part of the difficulty may lie elsewhere.

You have been very interested, for obvious reasons, in the automobile industry. I heard a calculation the other day that was of some interest in this connection. In the last 2 years, the average monthly payment on a typical 4-year auto loan for the purchase of a new car, has gone up around $54 or $55. That is a lot. That is the increase in the monthly payment on a 4-year loan. What causes it to go up by roughly $55? People immediately think of interest rates, and interest rates are, obviously, a factor in the increase. But when you figure it out, the increase caused by interest rates is about $9 or $10 since 1979, as I remember the number.

Senator RIEGLE. Are you referring to the financing charge?

Mr. VOLCKER. Yes, to the financing charge. The remaining $45 increase in the monthly payment is in the price of the auto; the typical car has gone up in price about 30-percent in the past 3 years.

Senator RIEGLE. Let me stop you there because it is an important point and before my time is up I want to get to something else. But in the cost of the product you are seeing the effect of high interest rates because that is coming to the pipeline from the suppliers to the end manufacturers. So that is a part of the problem.

Mr. VOLCKER. A small fraction of the 30-percent price increase reflects that.

Senator RIEGLE. It would be interesting to know precisely what it was.

Chairman DOMENICI. Senator, you indicated you wanted to finish this up because your time was about up. It is up.

Senator RIEGLE. I will be very brief.

CBO FORECASTS TREASURY BILL INTEREST RATE WILL DROP

Dr. Rivlin was here yesterday and brought with her the forecast in behalf of CBO. Her basic policy assumption on interest rates, and it is in yesterday's record, although it came late in the testimony, and I think most people missed it, she and the CBO make the assumption of an interest rate for the Treasury bill at a rate of 15½ percent in the third quarter of this year, dropping in the fourth quarter to 14½ percent.

In other words, she is seeing—they see a 2 percentage point improvement, quarter to quarter, the third to the fourth quarter.

My question to you is that from your vantage point, and I am not asking you to get into challenging their numbers, but I am wondering if that is a realistic assumption from your vantage point, that we can realistically expect to see a 2 percentage point improvement in the Treasury bill rate in the next 90 days.

Mr. VOLCKER. Yesterday it was about 14.30 percent. Sometimes it moves pretty rapidly. Those changes are not outside the range of fluctuation that we have clearly had recently, but I am not going to forecast any particular level of interest rates in the fourth quarter. The number you cite is not an impossible number, just based upon history.

Senator RIEGLE. The forecast for next year or the average for the year would be 12½ percent. Does that sound realistic to you?

Mr. VOLCKER. I would prefer not to suggest what sounds realistic or unrealistic to me. Some people think, as Senator Armstrong suggested, that I set the number. I do not. But I do not like to get into the process of forecasting it.

Senator RIEGLE. I am not sure who is in a better position to make an educated evaluation of the likely rates than yourself.

Mr. VOLCKER. Let me just say that it depends on a lot of things, including how strong the economy is. You can get into a kind of circular reasoning here. The Treasury is issuing an awful lot of Treasury bills and other securities, and that interest rate will be set by how many bills and other securities the Treasury issues next year. There is a huge Treasury financing that has to be done during the fourth quarter, which will have a very large bearing on whether Mrs. Rivlin's assumption is borne out or not, quite beyond anything we can do or forecast. There is going to be a record amount of financing in the fourth quarter which is illustrative of the problem we have.

Senator RIEGLE. Thank you.

I thank the chairman, too, as a courtesy.

Chairman DOMENICI. Thank you.

Senator Andrews?

Senator Andrews. Thank you, Mr. Chairman.

INFLATION HAS MAJOR IMPACT ON INTEREST RATES

Part of the testimony and the questioning this morning has begun to develop that you really do not have a major impact on interest rates. If you do not and the Fed does not, who does?

Mr. VOLCKER. Let me state it this way: I do not think we have a major impact on the kind of short-run maneuvering that is asked about. What will have a major impact is the inflation rate and prospect. I think we do have an impact on that, but that is an impact that works out over a long period of time.

Senator ANDREWS. Most people feel you do have an impact and therefore you are high on the hit parade for lynching. I just left a meeting of the Senate Appropriations Committee and the chairman, Mark Hatfield, said, where are you going, and I said that I was going over to the Senate Budget Committee hearing, and I said Paul Volcker is going to be here. I said, do you have any suggestions for him on how to benefit the economy, and he said, you bet I have, tell him to resign at noon. As you can see, some of us in the Congress are a little put out.

I may also say, Mr. Chairman, from a personal standpoint, I am a little like the kid who dropped his bubble gum on the chicken house floor. I am confused because in my other life, my real life, I feed cattle. You have got to make some conscious business decisions when you feed cattle. We are told that we have got to restrain money growth. We have got to have high interest rates to get inflation under control.

Last March we sold off 80 percent of the calves in our feedlot because we made a conscious decision that it does not make sense to pay $10 a head interest per month. More and more decisions are made that way. If it is costing me $125 per steer for inflation, that is about three times any normal profit any farmer ever dreams about, and it increases the cost of hamburger to that housewife that wants to buy it. It adds to inflation.

How do we come about this newfound idea, concept, that high interest rates somehow or another get inflation under control?

RESTRAINT ON MONEY AND CREDIT GROWTH ESSENTIAL IN CONTROLLING INTEREST RATES

Mr. VOLCKER. I do not think the way to look at it is to say that high interest rates get inflation under control. What is essential in the process of getting inflation under control is restraint on money and credit growth.

In a period like the present, when demands for credit are very high—and I cannot help but come back to the deficit as contributing to that—and big demands come up against a limited supply, you get high interest rates. That is not the object of the exercise; the object is to restrain money and credit growth and restrain inflation.

We would all like to see interest rates lower. It is a question of how to get there. I am saying to you that I am sure we are not going to get there unless the inflation rate comes down.

Senator ANDREWS. Unless interest rates come down, there is no way of getting inflation under control.

Mr. VOLCKER. I do not think that is correct.

As we have noted here several times already, inflation is lower, but interest rates are higher. You cannot find a general correlation throughout the economy between higher interest rates and higher inflation.

Senator ANDREWS. I am not an expert. I know a little bit about putting meat on the table and it gets me, these 20-percent interest rates, and there are fewer and fewer feeders that are able to continue feeding cattle. So, somehow, the consumer is paying in the end.

Mr. VOLCKER. The price you get for that cattle depends on the market for beef.

Senator ANDREWS. That is another thing. You do not have any control over the end price.

Mr. VOLCKER. That is the point I am making. We do not have control over the end price, but something is keeping the price of beef down.

Senator ANDREWS. But to get back to the confusion, yesterday Dr. Rivlin testified before this committee and she said that money growth consistent with Federal Reserve targets could prove to be incompatible with strong economic growth. Do you agree, and what do you foresee as the result? Which expert do we believe?

Mr. VOLCKER. The answer to that question depends basically on what happens to inflation. The more rapidly inflation comes down, the more room you will have for economic growth; I know no way to escape that. I may only have a half hour more in office but that problem is going to remain whether I am here or not, and I think that is what you are dealing with.

You have a trade off here. The quicker inflation comes down, the more vigorous the economy will be, consistent with our monetary policy, and the more sustainable that growth will be.

RAPID FIX NOT REALISTIC

Senator ANDREWS. Then in talking about a rapid fix, Mr. Chairman, if the Congress took immediate action to further decrease the Federal deficit, would we see an immediate response?

Mr. VOLCKER. That depends upon the action. More broadly, I would not encourage you to think in terms of a rapid fix. There is no quick fix. We have a problem that has literally been built up over 30 years, and built up decisively in the last 15 years. The idea that there is a rapid fix, that you vote on anything today to fix a problem built over 15 years is not realistic.

Senator ANDREWS. If we postpone the other side, if we postpone the tax cut for 2 years, if we could vote that through by some miracle in a week or two, would that have an immediate, and when I say immediate, I mean within a matter of weeks or a few months, would that have an immediate effect on the interest rates?

Mr. VOLCKER. I think it would have an effect on interest rates but given the inflationary problems, the effect would not occur overnight. You have to ask what is in the interest of the economy over a period of time, in terms of productivity and incentives and all the rest.

What that tax bill does is to adopt a point of view on what is necessary for growth and productivity over a period of time. I do not think anybody should think that those results will appear overnight—you cannot expect results instantaneously—but that does not mean that the approach is not valid. You voted the tax bill in July. We are now in the first half of September, less than 45 days later; the tax bill is not in effect.

In my opinion, you have not got the third leg of the stool—the spending side—in place. You should not expect instantaneous results. That does not mean that the reasoning behind the program—assuming you can put the program together and hold it together—is not going to be valid over a period of time.

Senator ANDREWS. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Andrews.

Senator Chiles?

LESS OPTIMISTIC ABOUT REAL GROWTH

Senator CHILES. Mr. Chairman, I am struck by the fact that the Federal Reserve is projecting about 2½ percent real growth in GNP for 1982.

Your range is 1 to 4 percent, CBO is projecting 4.1 percent and the administration says 5.2 percent. Is it your judgment that we can get up to the 4 or 5 percent range without rekindling inflationary pressures and sending those interest rates even higher? What is going to happen?

Mr. VOLCKER. Let me just say that those projections you refer to are Federal Reserve projections in a sense. They are collections of the views of the members of the Federal Open Market Committee and not, so to speak, an institutional view, which we really do not have.

I think it is fair to say, speaking for myself, that I would be less optimistic over the next 6 months, anyway, in terms of real growth, than some of the other projects you referred to.

What we are aiming at, betting on, developing our policies around, is the longer run. I personally would be somewhat less optimistic about real growth in a 6-month time horizon.

Senator CHILES. If we can get 5.2 percent real growth, and if you hold your monetary targets to 4 percent growth as your midrange next year, would that be compatible?

Mr. VOLCKER. I think it would be exceedingly fortunate to combine, in the short run, that kind of growth with that kind of progress on inflation and within the context of our monetary targets, to be sure. A lot of strange and unexpected things happen and economic forecasts are all subject to a considerable range of error, to say the least. But I would be surprised to see that much growth and that much going on in inflation, within the context of our monetary targets next year.

MONETARY POLICY ONLY RESTRAINING INFLUENCE

Senator CHILES. Based on the figures we got from Alice Rivlin yesterday—and you have alluded to those figures today—with the unspecified cuts plus the projection changes we are looking at possibly a $100 billion deficit in 1984. Given the fact that the President has now come out with what he proposes to cut in defense and has said that he is not going to cut social security, it looks like to me that if we go along with his plan and then pay the interest on the national debt to accomplish a balanced budget, we would be talking about cutting all of the other areas of government approximately 36 percent across the board.

A 36-percent cut would then have to be made in veterans payments, education, in our aging commitments, as well as in highways. That is everything that we are talking about, 36 percent across the board. I think we had a good scholarly exercise today about what we should do about spending cuts. But I do not think there will be many people who would say we are going to get 36 percent across the board in budget cuts. If we are not going to make these cuts, then we will be left with the situation that we find ourselves in right now in which monetary policy is the only restraining influence we can use to control inflation.

If we are left with this situation, then we come back to what Senator Riegle, Senator Armstrong, Senator Andrews, and others, have been talking about and that is the tremendous disparity that you have out there in which a number of sectors of our economy, and a number of people are dying with the high interest rates. On the other hand, you also have another sector that is booming, and includes defense contractors, energy contractors, and some of the major corporate giants. With a tax cut, this sector will be booming even more.

Now, the realities are that we are stuck with a tight monetary policy, and people are going to continue to look for a quick fix for the high interest rate situation. We have a number of bills introduced now to help out. But everytime I pick up the newspapers, I notice efforts to change the Federal Reserve system, and take away its powers.

Right now, you are the only person with the finger in the dike. Aren't we going to have to try to find some way to accommodate people who are wiped out? If not, we are going to have an explosion or, we will have to knock out the Federal Reserve Board altogether.

That last alternative looks like where we will have to point ourselves. You have given us a good lecture about how much we should cut in spending. I just do not think however that a 36 percent, across-the-board cut, is in the realm of possibility. A number of us feel you are trying to do the right thing, and that you are trying to follow a sound policy.

But if you have corporate giants seeking mergers and using the money they get from the tax cuts to buy up little companies, politically, we are going to have an explosion.

CHALLENGE OF CUTTING NOW WHAT CAN BE CUT

Mr. VOLCKER. You are the political expert. You have described the problem very well, I think. One comment I will make is that it is not an either/or; you do not go for either $100 billion of cuts or nothing. What I am saying, and perhaps what you are saying, faced with the problem that you described so well, is that the challenge before the Congress and the administration now is to do what cutting they can do. I do not accept, given the arithmetic you suggested,that we necessarily have heard the last word from the administration or the Congress on defense or on the entitlement side of the equation. I do not know what the answer is, but I know what your arithmetic is. I can only say that the implication of the situation is that you work with all the vigor at your command on that side of the equation. If it is not enough, you will have to face up to the implications on the revenue side. Shooting the messenger or the head of the Federal Reserve is not going to do anybody any good.

Senator CHILES. What I am saying is, given these kinds of factors—and maybe we will make some cuts which would be good—but it is going to be a lot easier to cut the head off the Federal Reserve system than make these huge cuts, but that is what I am afraid is going to happen.

Mr. VOLCKER. Let's just clarify the point.

It may be easier to cut the head off the Federal Reserve, but even when the Federal Reserve is running around headless you will still have exactly the same problem you started with.

Senator CHILES. We talk about beheading the Fed like we talk about the tax cut being too large now—after the fact; after the cuts have been made.

Mr. VOLCKER. I hope there is some realization before the action is taken that you are going to be left in the same place.

Senator CHILES. Well, I hope you are thinking about something like the voluntary dual prime rate policy that Arthur Burns tried to use, or at least something like that, because I think unless we can show the farmers and the small businessmen and the housing industry that we are concerned about their plight and that we recognize they are the victims of high interest rates, then I think you are going to have built up a pressure that will give us an unwise result. And that is something we do not want.

Chairman DOMENICI. Thank you, Senator.

Senator, before you start your questioning, I wonder if we could establish some ground rules for the remainder of the hearing.

I assume, Chairman Volcker, that you are prepared to stay here until at least 12:20, is that right?

Mr. VOLCKER. I will stay as long as necessary, Mr. Chairman.

Chairman DOMENICI. With that, let me state to one of the majority members, I have to leave in about 10 minutes. I do hope we would continue to at least 12:30 or later so everyone will have a chance and if there are any follow up questions, I hope you will be able to preside for me starting about 12 o'clock.

Senator Gorton?

EVIDENT THAT DEFICIT WILL BE CUT IN HALF

Senator GORTON. Mr. Chairman, as I understand your message to this committee and your message over the last several months, it has been that both inflation and interest rates will be lowered on any kind of long-term basis and only to the extent that we have the ability and/or the courage to reduce or eliminate the competition which the Government is now providing for a limited amount of savings in our economy unless you increase the availability for those savings for private investment.

And I also gather that your message is that you assume that we are going to work toward that end by reducing the rate of growth of Government expenditures.

Now, I would like to ask in a sense a hypothetical question. It is very important to us in making those choices. Let us assume that we did take fairly decisive action and that, in fact, promptly perhaps through the vehicle of the second budget resolution which is before us right now, the kind of action which would rather clearly put us on the road toward eliminating the Federal budget deficit by 1984.

One assumes, then, because of the answer you just made to Senator Chiles, let us take an interim assumption while we do not reach that goal entirely, at least it becomes quite evident that we are going to be halfway there and we will cut the budget deficit in half.

Can you give any kind of informed opinion as to what you believe the short and long range, anywhere from 3 months to a couple of years, of that kind of action would be on rates of interest?

Mr. VOLCKER. If your actions could be convincing, which is the premise of your question, I have no doubt you would have a very constructive effect on the bond market, in particular, and that you would see a strong tendency——

HALF OF CBO PROJECTION CUT

Chairman **Domenici**. Would the Senator yield for clarification? What was your question in terms of getting halfway, halfway with reference to what projections, to the $30 and $44 billion that you are required as cuts or to the estimated deficit of CBO?

Senator **Gorton**. Estimated deficit of CBO. You did not really differentiate.

Mr. **Volcker**. I am not sure; I am confused now.

Senator **Gorton**. I asked you really two different questions.

First, we were so successful that there was a distinct indication of high probability we would eliminate the deficit now projected by CBO by 1984.

Second, a reflection of one of your answers to Senator Chiles, we did a good job, we perhaps cut that projection in half. It would be a distinction between those those two alternatives?

Mr. **Volcker**. In half, with that kind of deficit.

Senator **Gorton**. Half of what, the CBO projection?

DEFICIT DETERMINED BY ECONOMIC ACTIVITY

Mr. **Volcker**. $25 billion; half of the deficit projected by CBO. The market is convinced that would help. I think your problem is one of being convincing; once you say that, you are going to have a lot of skepticism.

Let me put it in a somewhat different way that may be helpful. The size of the deficit in any particular year depends upon what is going on in economic activity. You cannot project that; we cannot project that; it is a source of confusion. It means quite a different thing for the deficit to be bigger because the economy is soft than it does if the economy is not. The expenditure patterns that the administration has laid out does seem to be consistent with a fiscal balance in a particular year, but that may be disturbed because the economy is soft; it is a reasonable expenditure trend to give you a healthy fiscal position.

But are you going to be on that trend or not? It is a very restrictive trend compared to recent history. It only goes up, depending on the year, 5 or 6 percent a year. But if you can hit that kind of trend, then you would be on the mark, so to speak, whatever the deficit was in a particular year.

BEING CONVINCED HAS POSITIVE EFFECT ON INTEREST RATES

Senator **Gorton**. Being on the mark, you think that would have a positive effect on both the rate of inflation and interest?

Mr. **Volcker**. Interest rates, yes, if you were convincing on that mark. I don't think the market, listening to all the comment made this morning, is convinced; a lot of people say it is impossible.

I cited in my testimony a figure of revenues falling to about 19 percent of the GNP, a 2-percent reduction from where we are; that is a lot of money. It returns us back to where we are in the mid 1970's. It is not a figure that is out of sight, historically, in terms of what we have spent as a percentage of the GNP.

People are asking whether you can restore a spending pattern over several years that is not as great a load; that is the challenge that is being presented.

REDUCE EXPENDITURES TO BALANCE BUDGET

Senator GORTON. There have been a number of suggestions here this morning that would be very difficult to reach fiscal balance simply by a reduction of expenditures and that some new sources of revenue or more likely a suspension or postponement of some portions of the recently passed tax cuts would be necessary in order to do so.

Again, I am going to ask you an artificial question in a sense. Is there any difference in your view on the strength of the economy in the future both as to the rate of inflation, rate of interest, the rate of growth whether we balance the budget solely and exclusively by reducing expenditures or solely and exclusively by increasing taxes and revenue; does the choice between those two courses of action have any economic impact?

Mr. VOLCKER. Yes; I think it does. From the standpoint of the productivity of the economy over a period of time—the strength of the private economy, the level of investment, the level of housing and so on—you will be better off reducing the expenditures than increasing the taxes to achieve the same balance.

Let us look at it from a purely economic perspective, leaving out defense and the social objectives. There is no question in my mind that on purely economic criteria the economy will function better at a lower level of taxes and a lower level of spending.

Senator GORTON. Thank you, Mr. Chairman.

SKEPTICISM BY FINANCIAL MARKETS NOT WARRANTED

Chairman DOMENICI. Thank you, Senator.

Now if you will permit me to interject one question.

I thank you Senator.

Chairman Volcker, in your statement to the committee, you said the following: "Under the circumstances it may be frustrating to observe the skepticism and doubts reflected in recent performance of many financial markets."

You said: "I believe that skepticism will be proved unwarranted." And went on to say what you thought did not necessarily go.

Chairman Volcker, it has been my recommendation to our leaders in the Senate and to the President that the skepticism was not warranted, but I believe a game plan that indicated that the President had proposals to basically effect carry out his program of budget cuts which, as I indicated to you before, contemplate an additional $30 billion in 1983, and $44 billion to $45 billion in 1984.

And before you answer the question, I want to tell you what that would mean. If nothing else occurred and the tax bill remained in effect as it is, the rate of expenditure of the Federal Government by way of annual increase would have changed in the following manner: For previous years an average growth increase in Federal expenditures of about 12.5 to 13 percent per year. With nothing further than what I just described, the rate of growth of the Federal budget would be reduced to an annual increase of 5.7 percent a year.

Now, it appears to me that when we consider that the business community and so-called Wall Street people advocated significant tax reductions and got them, advocate significant fiscal restraint, I submit if they reduce—if we reduce the Federal budget growth to 5.6 percent a year from almost 13 percent, that we would have given them fiscal restraint.

Now, I ask you whether you believe, since you indicate that you do not think their skepticism is warranted, would you believe that what I have just said is what is making the majority of them skeptical, that they do not believe that we have the plan to reduce their budget to that kind of increase per year?

GROWTH RATE REDUCTION WOULD PRODUCE PRESIDENT'S OUTLAY LEVEL

Mr. VOLCKER. I think that is a very big element in their skepticism.

To clarify this in my own mind, would that 5.7 percent produce the $760 billion that the administration has estimated in 1984, or a higher number?

Senator DOMENICI. The 5.7 percent reduction would produce the outlay level estimated by the President.

Mr. VOLCKER. Consistent with what you just said, if you can demonstrate that you are on a track toward the outlay level estimated by the President in 1984, as I understand it, under current tax structure, that would produce balance. It might not produce balance if the economy is not as good that year as projected. I think that is the kind of thing——

ADMINISTRATION COMMITTED TO FISCAL RESTRAINT

Chairman DOMENICI. I believe, Mr. Volcker, it is fair to say it would not produce balance, but the reason it would not is economic projections and outflow estimates where the military will flow out faster than estimated. If you add those up, that is most of the disparity.

Let me ask my last question: The economic recovery plan has not even had a chance to take place. The tax bill is not in effect until October. Inflation, albeit some would not think it is going to stay there, appears to most people that it is in the range of 8 to 9 percent. The only thing that seems missing is that we do not believe.

Now, Mr. Volcker, do you believe that we have had an administration in recent years that is more committed to fiscal restraint and that is more willing to restrain the Federal budget based upon actions to this point, by this President? Is he not as interested as any, has he not taken as different steps as any in recent history?

Mr. VOLCKER. Yes. As I indicated in my statement, the actions taken so far on the spending restraints have been greater than anything I have seen.

Chairman DOMENICI. So the only missing thing is they do not believe the remaining 2 years?

Mr. VOLCKER. I do not believe, given all the difficulties that enough action will be taken in the next few years to match the tax reduction. There is a lot that is not in place. I think we have to say that.

LACK OF RELATIONSHIP BETWEEN CPI AND PRIME RATE

Chairman **Domenici**. I would just close with this one observation, Mr. Volcker: In 1979, the Consumer Price Index averaged 13.3 percent. I do not recall the deficit. But I am sure it is as large as we are projecting for this year and for 1981 and certainly as large as projected for 1983. The Treasury bill rate was 10 percent that year on average. The prime rate was 12.6 percent. If inflation is 8.5 percent today, prime rate is 20 percent; that just does not make sense. The accumulative deficit that has been added is about $100 billion. I just do not understand the lack of relationship between CPI and prime rates based on historic facts and the Federal Government's so-called abuse of the markets, as you describe it, by having involved too much.

Mr. **Volcker**. I do not think you would expect that relationship to persist indefinitely. I think in the short run—and by short run I am now talking on a year-to-year basis—there is not that close a relationship.

Chairman **Domenici**. Thank you.

Senator Metzenbaum——

Senator Johnston was next, I am sorry.

Senator **Johnston**. Thank you, Mr. Chairman.

MODIFIED TIGHT MONEY POLICY

Chairman Volcker, the Federal independent agencies—and you talk to the President and do read the newspapers, your policy, whatever it is, it has been called modified tight money by the chairman here, is in fact the administration's policy, is it not?

Mr. **Volcker**. I think I am led to believe it is consistent with their thinking, yes.

Senator **Johnston**. Thank you.

Your projections, call them projections or components or whatever, vary from the administration and CBO markedly in particular fiscal year 1982, Senator Chiles talked about the difference between the administration projection of 5.2 percent and real GNP and your 2.5 percent. This would mean that your projection of deficit would have to be, therefore, considerably higher than that of either CBO or the administration, would they not?

Mr. **Volcker**. Other things equal, the revenue side would be lower; yes.

Senator **Johnston**. If CBO projects for fiscal year 1982 a deficit of around $62 billion, what would the Federal be?

Mr. **Volcker**. We do not have any official estimate of deficits, but our staff may not be widely out of line with the CBO estimates. Presumably if the economy was slower——

Senator **Johnston**. Would that have been at least $70 billion, $80 billion?

Mr. **Volcker**. If Congress does not take any more action.

Senator **Johnston**. Based on the same assumption of CBO with your different projections, you would be $70 billion to $80 billion while CBO was $62 billion. Is that correct?

Mr. **Volcker**. I am not familiar enough with all the spending estimates and the adjustments CBO has made to the administration's forecast, and so forth, to want to be pinned down very closely. I think on the higher side; yes.

NEGATIVE REFLOWS

Senator **JOHNSTON**. Now, there is a phenomenon that we have discovered here, at least I discovered here on the Budget Committee, called negative reflows; that is, when you cut a dollar spending, it does not give you a dollar off the deficit. It gives, what, maybe 70 cents or something off the deficit in order to—if the deficit for fiscal year 1982 is $70 to $80 billion, then you have got to cut in the neighborhood of what, something more than $70 billion or $80 billion?

Mr. **VOLCKER**. I do not know what analysis you have in mind. You are probably assuming that if you cut spending, the economy will be lower and, therefore, you do not——

Senator **JOHNSTON**. That is right. If you spend as much on defense, then the defense contractors do not make as much——

Mr. **VOLCKER**. I am not at all sure that analysis is relevant in the current situation because with the economy being restrained by the shortage of money and shortage of credit, to the extent Government spending is cut, I think in the present situation you may well find the private economy balances things up to make up for that impact, and so you would not get the revenue loss of the kind you would ordinarily expect under other circumstances.

IS SUPPLY ECONOMICS STILL VALID HOPE

Senator **JOHNSTON**. Chairman Volcker, the President has come out with very modest cuts, projection of cuts in defense. He says he will not make any changes in entitlements, at least not this year. He wants to stick with his taxes, and we think we have come to an agreement that the cuts cannot come from another place. And those of us who voted for and supported the program want to believe, really do, and I think the American people want to believe. But at what point do we say that the element of faith and hope, this intangible new thing called supply side economics, the Kemp-Roth feedback element, when do we reject that and find that wanting to go down a new road and should we stay on that road and say it is still a valid hope?

Mr. **VOLCKER**. The answer to that question in a sense would be in your hands, in the Congress hands. If you are really telling me you cannot make those spending cuts, then you have got to begin thinking of changes in other directions.

Senator **JOHNSTON**. You see, the administration told us, Mr. Stockman, I have his testimony over there, that we were not going to have to go through this exercise this year. It was going to work. There was a new element in this economy that if we get the tax cuts, give business what it wants, things will improve. There was nothing about a $70 billion to $80 billion deficit in fiscal year 1982.

Mr. **VOLCKER**. I think there was. Maybe it was not emphasized enough, and the numbers may have changed some. The administration all along has had $15 billion or so more of cuts in there and you have had those in your budget resolution, but the Congress has not acted; those are there as an assumption, not as an action, and I think that is what we are talking about in fiscal 1982. If you go out to fiscal 1984, as I said earlier, I can add up $38 billion worth of spending cuts that were in the administration program, but either the administration has not yet suggested in which direction the cuts should go or they have suggested and Congress has not acted. The great bulk of spending cuts were in those documents at least.

Senator **Johnston**. Well, I beg to disagree. When I talked to Mr Stockman here before this committee, he said: If you will give us the spending cuts, I think there were $44 billion, he said, "We are 75 percent home." I said, "Are we going to have to go in and go through this exercise every year?" He said, "No; we do not think so. We will be 75 percent home." And that in effect turn around this mentality, the business community is going to change these economics.

And now things are worse than they ever were. Jimmy Carter never had a $70 billion to $80 billion deficit.

ECONOMIC ACTIVITY AND INFLATION SHOW PROGRESS

Mr. **Volcker**. I do not think things are worse than they ever were in terms of the economy. Interest rates are high, long-term interest rates are higher, but short-term are not since you acted.

So far, the level of economic activity has been maintained and inflation has been showing a little more sign of progress than could have been expected.

Senator **Johnston**. My time is up. I do not want to cut you off. I hear you when you say skepticism is not warranted and I am trying to believe that. But my credibility is being stretched.

Mr. **Volcker**. I have to remind you that you are either going to make those expenditure cuts or you are going to find another revenue source; of that I am confident.

Senator **Symms**. Thank you, Senator Johnston.

Senator Sasser?

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Thank you, Mr. Chairman.

Chairman Volcker, I want to welcome you here today to these hearings. Since the Federal Reserve Board has become a household word with American business these days, I do appreciate your taking the time to meet with us and explain to the committee how the Federal Reserve Board's monetary policies are affecting our economic recovery.

HIGH INTEREST RATES AND TIGHT MONEY POLICIES

Mr. Volcker, back in March of 1980 you appeared before the committee, you and I discussed the subject of interest rates and their effect on the economy. You maintained that high interest rates and your tight money policy would drive inflation down and at that point in your own words, ". . . and I am perfectly confident that as that happens interest rates will come down."

Well, Chairman Volcker, I am afraid that your economic forecasting is on a par with most other economists in this town—it simply has not happened.

We have seen some moderation in the rate of inflation but largely because the lid has been kept on food and energy prices over the last few months.

We have just passed a truly historic program of cutting taxes and spending designed to encourage private sector growth and investment, but the stock market and the bond market is in shambles and key sectors of our economy—automobiles, housing, farming, and small business—are facing economic ruination.

In short, Chairman Volcker, your high interest rate and tight money policies have not worked. They are a major obstacle to our renewed economic growth.

And I believe that your high interest rate policies are flawed in three fundamental respects.

DAMAGED KEY SECTORS OF OUR ECONOMY

First, they have damaged key sectors of our economy. Housing production is reaching its lowest level in about two decades. Average mortgage rates are approaching 18 percent, and perhaps less than 5 percent of the American home-buying public can afford to buy a home. And my friends at the homebuilders association have told me that one-third of the Nation's homebuilders have simply left the field.

Automobile sales stood at a level of some 8 million units in the second quarter of 1981 while they were about 11.5 million units in the first quarter of 1979. And some 2,600 automobile dealers have left business permanently.

Farm interest rates have skyrocketed, farm debt is at an alltime high, and interest rate costs account for about 100 percent of farm production costs in 1980 alone.

For these sectors of the economy, high interest rates have been a death blow.

UNDERMINED AMERICAN BUSINESS CONFIDENCE

Second, high interest rates and tight money have seriously undermined American business confidence.

On September 13, 1981, Dun & Bradstreet reported that through the week of September 3, business failures stood at more than 11,000, up 42 percent from a year earlier. They expect that by year-end as many as 13,000 businesses will close their doors, bringing us the highest business failure rate since 1965.

The stock market has slipped drastically, and economic activity has all but ceased on the bond market. And though the demand for business credit remains strong, little of our Nation's capital is being put into long-term investment.

In short, Mr. Chairman, high interest rates are not promoting the economic growth this country so badly needs. Your interest rate policies have received a vote of no confidence from American business.

IMPOSSIBLE TO BALANCE BUDGET BY 1984

Finally, high interest rates and tight money policies will make it impossible for us to balance the budget by 1984.

Yesterday, the Congressional Budget Office reported that they expect interest rate outlays to be $40 billion more than administration projections due to the administration's own unrealistic projections of interest rates through 1984.

And we know from other CBO economic projections that if real GNP growth falters because of high interest rates by just 1 point below administration projections, we will have about $38 billion less in Federal revenue between now and 1984.

Adding the two together, we face a situation where the cumulative budget deficits between now and 1984 will be increased by $78 billion between now and 1984.

When I see that, I find it little wonder that we are going to have a hard time in balancing the budget by 1984 unless and until interest rates come down.

In conclusion, Mr. Chairman, your interest rate policies are causing serious damage to our economy. We simply cannot have an economic policy which seeks to bolster American business and consumers by cutting spending and taxes while we have a monetary policy which holds down economic growth by tight money. American business stands ready to rebuild our economy and make it grow again. American consumers stand ready to buy in a stronger economy.

But that will not occur, Mr. Chairman, unless and until the Federal Reserve Board turns away from its present policies of high interest rates and tight money.

Thank you.

Senator **SYMMS**. Chairman Volcker, is it my understanding that you can stay until 12:30?

Mr. **VOLCKER**. Yes.

Senator **SYMMS**. The committee will stand in recess. We have a vote on the floor and we will be right back with several Senators who want to ask some questions. And if you will be patient we will be right back.

(A short recess was taken.)

RELATIONSHIP BETWEEN 3-MONTH T-BILLS AND PRIME RATES

Senator **GRASSLEY**. The meeting will reconvene.

My question to you, Mr. Chairman, concerns the historical relationship of 3-month T-bill rates and prime rates.

You may doubt whether much can be measured by that comparison. I am assuming, however, that there is a link between that and what interest rates ought to be.

In 1979, the spread between 3-month T-bills and prime rates was 2.6 percent, in 1980 the spread was 3.84 percent, and in the first 6 months of this year that spread has been 4.42 percent.

I would like to ask if you think this could indicate that banks have actually made large profits with rising interest rates and whether this should be an indication that banks could stand to lower interest rates?

PROFIT MARGINS ON BANK EARNINGS LOWER

Mr. **VOLCKER**. I think the record on bank earnings would not show any exceptional profits this year. I do not have the figure offhand. My impression is that profit margins overall, taking account of all expenses, may be somewhat lower this year, at least among the big banks, than they were last year. If you look at the the bill rate or CD rates, which are closely related to bank cost—then the prime rate would appear to be somewhat high relative to those money market rates today. The money market rates have been coming down fairly rapidly, and the prime rate has come down very little during this particular period.

Senator **Grassley**. So as far as you are concerned, then, that spread is no indication that interest rates should be lower than what they are?

Mr. **Volcker**. Looking at it over a period of a year or so as you did, it is not an indication, at least that bank profits have been abnormally poor in my judgment over that period. The picture is different right at this instant.

Senator **Grassley**. But, since the spread is increasing and a large share of bank investments were to be in T-bills, shouldn't interest rates come down?

Mr. **Volcker**. Banks hold very little in the way of Treasury bills. They borrow a great deal of money in terms of time deposits. The important relationship is between those borrowing costs and their lending rate, which is only inadequately reflected in their prime rates. The prime rate is high today relative to money market rates.

RELATIONSHIP BETWEEN M_{1B} AND M_2

Senator **Grassley**. I would like to go on to another point, then. You have been fairly successful, in the past 6 months, in keeping M_{1B} on or below the target range. The M_2 has continued to run above the target range. Some market analysts think that M_2 growth is largely due to accrued interest on balances, included in this measure of money rather than the customer preference for any one particular type of an account.

Would this show that the relationship between these two aggregates is not completely accounted for in the Fed's monetary range? Does the Fed understand the differences between M_{1B} and M_2. In other words, the actual relationship between the traditional measures of money. Since the traditional definition of money seems to be inadequate, should we direct our attention to a better range such as the monetary base?

Mr. **Volcker**. Let me say M_2 is barely above the upper end of our target range at this point. A few months ago it was a little below the upper end of the range. We understand pretty well that we can never identify down to the *n*th degree why greater divergence has developed between M_2 and M_1 this year; it was not contemplated when we set the targets this year. I will just mention a few of the factors. As I said earlier, I think the increasing use of money market funds as transactions balances has permitted people to economize more this year on the traditional transactions balances that we include in M_1, to a greater degree than we really anticipated, as reflected in explosive growth of money market funds. Those same money market funds have attracted money out of the open market to some degree; we see more in M_2 than we might have anticipated because people who might have otherwise, let us say, held Treasury bills—that are outside M_2—have bought money market funds, which are in M_2.

I could name other factors as well, but that is one illustration of why these numbers have diverged quite a bit more than we expected at the beginning of the year.

BETTER RANGE IN MONETARY BASE NO SOLUTION

Getting to the last part of your question, there is no doubt that we are in a period of extremely rapid institutional change in the financial system. Money market funds are just one reflection of that. As money market funds get more closely tied with the day to day management of balances by individuals, we will see more economizing on demand balances and movement into other forms of balances. We have this whole phenomenon of so-called retail RP's developing in very elaborate form in recent months. In some cases, these can be a substitute for traditional forms of money. We have to continue to examine the impact of all these things. But I do not think the answer can be found simply looking at the monetary base. The monetary base is currency, which is one component that remains pretty steady, and bank reserves. Bank reserves happen to be a fraction of M_1. If M_1 is off, that fraction is going to be off, too. If M_1 is changing in meaning, the change in meaning of the monetary base will be different because it is weighted differently. I do not find a solution to this problem in simply turning to the monetary base.

Senator **Grassley**. My time is up, but I want to ask if you are going to make some adjustments for these problems?

Mr. **Volcker**. We make adjustments in our thinking as we go along. That is why we would not be satisfied with an M_1 as low as it is, if we were not taking into account the factors I mentioned and the fact M_2 and M_3 are running high.

Mr. **Grassley**. Senator Metzenbaum?

RESTRUCTURE FEDERAL RESERVE BOARD

Senator **Metzenbaum**. Mr. Volcker, as you know, we have discussed, Senator Hawkins and I, and produced legislation to restructure the Federal Reserve Board so that the President might have an opportunity to name nine new members to that Board. I have no reservations in saying to you that—and said to you privately, this is not a personal matter, but it strikes at the very heart of the question of whether or not it is your policies that are in the best interest of our Nation's economy; and it would give the President the opportunity to accept the responsibility for the preparation and determination of the Federal Reserve Board.

Frankly speaking, for 2 years now we have heard the Federal Reserve tell us that you need tight money and high interest rates in order to fight inflation.

In all fairness, even before you took over at Federal Reserve Board, the same argument was being made.

Now, we know inflation is around 8 or 9 percent and interest rates are 20 percent. And I am wondering whether or not you do not agree that it is time to take a new look at the question of whether or not tight money and high interest rates is truly the appropriate answer. Whether it is yesteryear's answer to do anything with the problem, whether the fact there is not a lack of supply of money regardless of how tight you make the policies of this Nation, you are aware of the fact that when companies wanted to make acquisitions in the energy area, that du Pont, Mobil, Texaco, Seagram's and Pennzoil all were able to go into the money markets and get about $30 billion of commitments almost overnight. Under those circumstances, is it not time we take a new look—and I would hope it would be your Federal Reserve Board that would do it it—if not, then perhaps a new Federal Reserve Board in the course of an inquiry. I recognize that Mr. Beeman and Mr. Wiedenbaum were attempting to nudge the Federal Reserve Board for its lower rates. Our legislation would mean they will not have to nudge, they could really achieve the objective.

INDEPENDENT FEDERAL RESERVE OR NOT

Mr. VOLCKER. I do not interpret their comments as nudging. I think they were pointing out, as I said, that M_1 has been running somewhat low; people should not take umbrage at a higher level should that develop.

You raise two fundamental questions, Senator. The first question, about reappointing the members of the Federal Reserve Board, seems to me to go very simply to whether you want an independent Federal Reserve or not.

Senator METZENBAUM. We did it in 1935.

Mr. VOLCKER. Originally in 1913 and again 1935, so its independence has been around for a long time.

I happen to believe that that was a wise decision by the Congress, and a decision I think that the Congress has reiterated implicitly and explicitly through the years. It would be a very major change in our institutional arrangements for economic policy in general and monetary policy in particular. Congress can of course change the arrangement, but you would not be doing it on my advice, quite obviously.

Senator METZENBAUM. It wouldn't be political?

DESTROYING INDEPENDENCE OF FEDERAL RESERVE NOT ADVISED

Mr. VOLCKER. I am not dealing with the political issue.

I just wanted to bring to your attention that you would be destroying by that avenue the independence of the Federal Reserve as a creature of the Congress and, in effect, making it a branch of the administration, and that would not be my advice to you in fair weather or foul.

I think these arrangements were made partly because of the probability of foul weather arising upon occasion.

Senator METZENBAUM. Well, we will have to sit totally idly by and do nothing.

Mr. VOLCKER. The Congress, in the last analysis, can do what it wants to do, but I think Congress in its wisdom has decided to provide a certain degree of insulation for the Federal Reserve Board from precisely the kinds of political pressures that you and I and everyone feel at the moment.

Senator METZENBAUM. The total consensus, let's assume there were total consensus, shouldn't Congress take some action particularly since we are a Congress of mixed political mean, and give the

President an opportunity to take some action? The whole country is crying out for action.

Mr. VOLCKER. The Federal Reserve exists on the premise that the President appoints and the Congress confirms the most knowledgeable people they can find to deal with these complex matters.

If we can turn to your other question——

Senator METZENBAUM. Maybe Congress itself helped create the problem by following the administration's urgings. When you were here before this committee on July 24, 1980, you advised us against the general tax cut, your quote was, "Conditions have not been put in place for a major tax deduction in 1981."

You said that Congress might take a careful look at relatively small revenue losses and said that Congress should strive to get the most bang for the buck and hold revenue loss to a minimum and then you went on to say apropos the question of a balanced budget, you said, "The balanced budget is an important goal but emphasis should be more on the outlay side than the deficit, per se, the spending spread is the crucial factor here."

Mr. VOLCKER. That sounds like what I said this morning.

Senator METZENBAUM. That is exactly what you said, except it was premised on the basis that there would not be substantial tax cuts which were part of your urging. In view of the fact Congress has made those substantial tax cuts, is it not appropriate that you evaluate the question and your answer as pertains to what Congress should or should not make was tax cuts as some other members of the committee have heretofore asked you?

GET SPENDING IN LINE WITH TAX CUTS

Mr. VOLCKER. I think my position on this has been consistent all along.

I could quote from testimony before this committee and other committees that I was reluctant to see tax cuts before the spending cuts were in place.

The Congress put some spending cuts in place. The tax reduction is not significant in 1981, which was an issue in my earlier statements. There are more spending cuts possible in 1981 than there are tax cuts. But the Congress has gone ahead and enacted tax cut beyond the horizon of the spending cuts that have been made and actually put in place.

I think that is the issue we were talking about this morning. That tax cut has been done. Now the job is to get the spending in line with what has been done on the taxes. I think my position on that has been completely consistent all along.

INTEREST RATES

I would be happy to comment on the second question that you raised about interest rates, and to repeat at least a bit of the conversation we had privately during the brief recess.

I think it is true and accurate to say that these days monetary restraint and pressures on current markets impact much more fully on interest rates than they would have 10 or 15 years ago because the structure of the financial market has changed. In what I may call "the good old days"—people didn't think they were the good old days at the time—when you had monetary restraint, there were a lot of factors—institutional, government, and administrative—that put ceilings on rates and created shortages of funds in particular sectors of the market, particularly in the fiscal institutions, such that before interest rates went up—before they went up very far by today's standards—the money flow was cut off, and we had what used to be called "money crunches."

Almost all economists and public officials thought that money crunches, where people could not get money regardless of what interest they could pay, were terrible. Partly as a reflection of public policy—not my public policy, but the public policy of the Congress and of regulators of various administrations through the years—these interest rate ceilings have been raised and have little practical effect now; institutions have been changed.

We have had a revolution in technology. We have had a revolution in communications. We have had new institutions arising. We now have the pressures growing out of interest rates themselves. The markets are much more flexible, so what happens now when you have restraint is that you get more of it reflected in interest rates. And 99 out of 100 economists think that is a great achievement. It is recognized that is what has happened, you have higher interest rates than you would have had under those old conditions, because under the old conditions there would have been an absolute shortage of money that would have brought the economy to a halt; it did bring the economy to a halt and then interest rates went down.

We don't have that. The economy neither has come to that kind of a jerking halt nor have funds necessarily been cutoff.

People think that is a positive development, but there is no question that interest rates are higher than they would have been under the old institutional arrangements.

You could raise questions with the benefit of hindsight as to which is the best institutional arrangement. I have to live with what I have. It is true that we have a situation today in which interest rates are very high but people who are willing to pay the interest rates can get the money. That was not true 15 years ago.

HIGH INTEREST RATES HURTING FARMERS, SMALL BUSINESS, ETC.

Senator **Metzenbaum**. Mr. Volcker, I appreciate your responses. You have indicated you have been to Brazil to see what inflation is doing. I have been to Cleveland and Youngstown and Akron to see what high interest rates are doing to farmers and small business people, workers, plants laid off. I think that that also should be enlightening.

Mr. **Volcker**. I have been to some of those places.

Senator **Metzenbaum**. I think you ought to understand the turmoil and travail occurring.

Mr. **Volcker**. I hate to sound like the same old record, but I think the whole object of this effort by the Congress and the Federal Reserve must be to restore conditions in which that kind of problem is not going to recur and persist.

I am afraid if we don't stick with our policies, it is going to recur and continue to exist and get worse, and that is the whole object of what we are trying to do and I hope you can appreciate that view of the matter.

Senator METZENBAUM. Thank you.

RELATIONSHIP BETWEEN M_1, M_2, AND M_3

Senator SYMMS. Thank you very much, Senator.

Mr. Chairman, I have a couple of questions I want to ask, and Senator Quayle and Senator Sasser would like to ask you some questions.

I know that you wish to leave the room as soon as possible so we will try to expedite the remaining part of the hearing.

But what I want to get at was the relationship between M_1, M_2, and M_3.

According to your own figures, M_1 has been increasing since January at 8½ cents a month——

Mr. VOLCKER. M_1? No.

Senator SYMMS. According to your own statistics, M_1 has been growing at a rate of 8½ percent interest.

Mr. VOLCKER. No.

Senator SYMMS. Since January?

Mr. VOLCKER. Since January? M_{1B} adjusted for NOW account shifts has increased at a 2.6-percent annual rate through this August.

If we measure from the fourth quarter of last year, which is conventionally how we measure our targets, it would be somewhat less.

But M_1 from January to present adjusted for shifts into NOW accounts was about a 2.6-percent annual rate.

Senator SYMMS. My understanding, the Fed told us M_2 and M_3 is another matter.

Mr. VOLCKER. M_2 and M_3 have been running above the range. M_1 is running below; M_2 and M_3 are above.

Senator SYMMS. At the Fed you actually don't control M_2 and M_3 to that degree, do you?

Mr. VOLCKER. I am not sure we control M_1 to that degree. These aggregates undergo a lot of fluctuation in the short run. Our control mechanism is more direct for M_1.

MARKET REFLECTS TOTAL GROWTH OF MONEY SUPPLY

Senator SYMMS. What I am trying to get at, don't you think that the—do you think, I should say, that the market is reflecting the total growth of the money supply?

Mr. VOLCKER. Yes.

Senator SYMMS. And that is why the interest rates are continually being pressed upward?

Mr. VOLCKER. I wouldn't accept the latter part of your statement.

Senator SYMMS. I am asking a question——

Mr. VOLCKER. Obviously the markets are reflecting a total supply and demand for credit situations. The issue can be put very simply: Would we have higher or lower interest rates over a period of time if we pushed those figures up? I think, over a long enough period of time--you can argue as to the precise timing—almost all economists and others would agree that market people operate on the expectation that the higher those figures are, the higher interest rates will be. That is because inflation would be higher.

Senator SYMMS. The market setting those rates, not stock market or anything, not the Federal Reserve, the market or reflection of people anticipating continuation of expanding creation of——

Mr. VOLCKER. Exactly.

HOLD MONETARY AGGREGATES TO STABILIZED GROWTH PATTERN

Senator METZENBAUM. Do you have any suggestions as to how the money, monetary aggregates, could be held to a stabilized growth pattern so there would be more predictability and less apprehension?

Mr. VOLCKER. I don't think there is any mechanical device with which you can buy that. It comes back in the end to a question of what we do, whether, in the common vernacular, we ease up and pump up the money supply.

It's intentions rather than the mechanics that count.

SELL GOLD BONDS TO FINANCE PUBLIC DEBT

Senator METZENBAUM. Isn't the interest on the Federal debt which coming due compounding and making your problems more difficult just a simple refinancing of a nearly trillion dollars?

Mr. VOLCKER. In a direct sense, it adds to the budget deficit. It makes the budgetary problem more difficult.

Senator METZENBAUM. So, economists are recommending that the Government sell gold bonds, gold backed bonds, to help finance the public debt.

Do you think that this would have any potential as a way to bring down the cost of interest on the debt?

Mr. VOLCKER. No.

Senator METZENBAUM. Explain why?

Mr. VOLCKER. I think the problems are more fundamental than gold indexed bonds.

It may look like you get a lower nominal interest rate. Some foreign countries try that from time to time. All the ones I know of are sorry, because it is seeking a kind of a "gimmicky" answer to the problem instead of a real answer.

I know sometime ago, on two occasions, the French sold gold indexed bonds. They got a cheap rate in the sense of immediate interest rate, but they are paying very dearly for those bonds now with the present price of gold.

Senator METZENBAUM. If we continue to go on the course that we have historically for the last 30-some years or so of continual expansion of paper money, will you anticipate gold will over a long trend, is going to continue to take more dollars to buy an ounce of gold?

Mr. VOLCKER. If we continue on that course. Of course, I am here trying to make the point that we are not going to go on that course, Senator Metzenbaum; that is not my intention.

CUT SPENDING MORE DRASTICALLY

Senator METZENBAUM. I appreciate the dilemma I am sure you are in. I think that Senator Armstrong and others have made the point and I think you're probably well aware of it, it is a critical problem on Main Street, U.S.A., of the squeeze that we are in. And I can't see anyway out of it except for Congress to cut spending even more drastically than they have.

Mr. VOLCKER. That, of course, is what I am saying; that is, I think, the fundamental approach to the problem. In terms of the man on Main Street who is upset, confused in some cases, under very heavy pressure, I don't know of any answer other than to point out and reiterate that this is a very serious, long-term problem we have gotten into and there is no easy answer to it right at the moment. Nobody can wave a wand and produce an answer to this problem in the next 2 months.

We are at a critical juncture. As I said in my statement, I think we were at critical junctures before and we failed. Now we are at a new one, and I think we better not fail on this one in making good on the promise and progress that has been made to a limited degree, as reflected in the inflation numbers.

Senator METZENBAUM. I will ask one last question.

FINANCING FEDERAL DEBT CONSUMES 25 PERCENT OF SHORT-TERM CREDIT

What is the most recent percentage of the immediate short-term credit that is being consumed by financing Federal debt?

Mr. VOLCKER. The figure I used in my statement is about half of the net savings. If you look at it from the standpoint of total flows of credit to the economy, which includes gross savings and a lot of borrowing and lending which may not be reflected in the Federal savings figure, I think the Government preemption, including off-budget programs, runs in the neighborhood of 25 or 30 percent of the total of credit in a year.

I would have to check that for the record.

[Chairman Volcker subsequently submitted the following information for the record:]

Direct Treasury borrowing alone—not including sponsored agencies, gurantees or other Federal auspices—accounted for 20 percent of total funds raised in the first three quarters of 1981.

Senator SYMMS. Thank you very much.

Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Chairman Volcker, you and I have discussed the question of interest rates on a number of other occasions and I recall back in March 1980 when you appeared before this committee I just returned from my State where I met with a group of farmers, who at that time were shocked and very angry they were being asked to pay interest rates at the rate of 15 to 16 percent.

That anger has now turned, 16 months later, 15 months later, to desperation. In some cases, despair.

MONETARY POLICIES ALONE CAN'T SQUEEZE OUT INFLATION

You said something today that I was delighted to hear you say, and that was that we can't squeeze inflation out of this economy by monetary policies alone.

I couldn't agree with you more on that. I have taken a position for sometime that these high interest rates are in and of themselves inflationary because high interest rates are significant contributing factors to inflation.

Remember back in March 1980, when you made that point before this Budget Committee. A number of my colleagues later spoke to me as if you would speak to a small boy, and just said, "Why, Senator, don't you know that these interest rates, we got to have these interest rates to combat inflation, just got to do that."

Are you testifying that if we maintain stringent monetary policies we drive down inflation? We maintain the high interest rates, and in your own words, and I quote, you said, "I am perfectly confident if we maintain stringent monetary policies and high interest rates that automatically interest rates themselves will come down."

Well, we have certainly maintained the stringent monetary policy and we certainly maintain a high interest rate, and there has to be some relief in inflation.

Just yesterday, Dr. Rivlin testified before this committee that inflation had moderated the first half of 1981, and this is due largely to favorable developments in energy, the oil producing countries are pushing oil prices at the dramatic rates they were last year, due primarily to increased less inflation food market and also to give the Devil his due, Mr. Chairman, referring to you, of course, but there is a marked depreciation in the dollar in the foreign exchange market, I think that can be attributable to some extent to high interest rates.

INTEREST RATES NOT TRACKING WITH INFLATION

My question is this, Now: You said in your testimony back in March 1980, if we kept the interest rate up, pursued the strict monetary policy that we would start seeing inflation coming down when the inflation came down, the interest rates would come down.

Well, we are seeing the inflation come down now, but the interest rates are not tracking at all.

What is the explanation for that?

Mr. VOLCKER. I am not sure I ever said that keeping interest rates up was the object. I certainly said that we had restrictive monetary policy with the object of getting inflation down. As you point out, we have seen some progress, I think maybe a little more than you give us credit for, due to monetary policy already. There are other factors. I don't think OPEC just dreamed up, out of the goodness of their hearts, restraint on prices in the past months. The only answer I have for you, basically, Senator, is that this process takes time. We are beginning to see some progress.

I am greatly heartened by the progress. There is a long way to go, and clearly at this point, for a variety of reasons, including the budgetary reasons which are so apparent to us this morning, and as reflected particularly in the long-term rates, the market has not become convinced that progress on inflation is going to continue and that pressures on the credit markets will be relaxed. I think that is a matter of time, given the right policies.

PERCENTAGE SPREAD BETWEEN INFLATION RATE AND PRIME RATE DOUBLES

Senator **Sasser**. Traditionally, we have seen that interest rates would run 2 to 3 percent above inflation, but we are seeing now is it is not uncommon to see a spread in the prime rate of 5 to 7, and sometimes close to 10 percent between the rate of inflation and the prime interest rates.

Now, what accounts for this?

Mr. **Volcker**. I think two things basically account for that. The first is a point that has been made repeatedly, particularly when you look at long-term rates and at the burdens put on monetary policy; there is not the degree of confidence that is necessary to induce lenders to commit money for a long period of time, or to discourage borrowers from borrowing money for a long period of time, at lower interest rates.

That is what the market is telling us. Why? Because they have seen a record of inflation over the years. They have seen inflation, not just in the last 6 months, but over the last 15 years, rising. They have seen repeated efforts to deal with inflation not carried through. They have a skepticism about whether this particular effort, which I think is by far the strongest and most promising we have had, will, in fact, carry through. They are expressing their doubts. To the best of my knowledge, we have never before in the United States had an inflation so persistant and so serious as this one.

For awhile, interest rates were very low relative to the inflation rate, because I think people went on the presumption that it wasn't going to last. I would suggest to you that what has happened in the last few years is that there has been a certain sense of giving up: People say, "No, this economy is going to inflate indefinitely and probably get worse rather than better."

That is reflected in the financial markets, and we have not completely turned around that mood. That is the first part of my answer.

The second part is that we never had any inflation or interest rates like this with the kind of tax rates we have now. As you know, to many borrowers and lenders, the interest rate, which is quoted as 17 percent if you are a lender or 20 percent if you are a borrower, isn't really nearly as high after taxes as those nominal rates suggest.

Senator **Symms**. Thank you, Senator.

Senator **Sasser**. Let me finish, Mr. Chairman, with one quick statement.

I could ask you a lot more questions about this, Mr. Chairman, and hopefully sometime in the near future I will have the opportunity.

PRESENT COURSE OF MONETARY POLICIES COULD RUIN ECONOMY

I fear if we continue on the present course with monetary policies that we are pursuing, that we are going to end up with low interest rates, we are going to end up with strong currency, and we are going to end up with a ruined economy.

We had in 1931 low-interest rates and we had a strong economy. We also had unemployment figures approaching, exceeding 50 percent. I talked to the farmers and auto dealers and homebuilders, small business people in my State, and I see the seeds of that kind of economic downturn germinating, and it is a frightening thing to behold.

Mr. VOLCKER. Let me suggest to you, Senator, that I have the same concerns you have.

The question is, what to do about it?

Pumping up the money supply isn't going to cure that problem; it is going to make it worse. This is precisely the issue we are talking about this morning. You can make this policy a lower risk policy. You can deal with those concerns that you have and you have so rightly by reducing the flow of funds in the money market that are involved in that government deficit. I think this whole hearing is about those very risks that you point to and what actions are necessary to minimize those risks and produce a healthy economy.

I tell you that if you leave all the burden on monetary policy to deal with this, you have increased the risks rather than diminished them.

That is why I am before you today making a plea that you share the pain, and that you do it in the only basic way we know how to do this. Let's get the government out of such heavy competition in these financial markets, so that the farmer you are worried about and the small businessman you are worried about and the homebuilder that you are worried about can come to the economic table, too.

That is the way to cut down the risks ahead, to deal with the inflation, and to have a more stable economy.

Senator SYMMS. Thank you very much.

Senator Quayle has waited a long time, and hope you can bear with us for another minute or two.

Senator QUAYLE. I think it is past the hour of 12 noon, and you are still with us

Senator SYMMS. It is long past 12 noon.

It is past 1 o'clock.

Senator QUAYLE. Mr. Chairman, to pick up where Senator Sasser left off, if you go back and conscientiously look at the fifties, you had a CPI of about 1 percent average for the decade, 1 or 2 percent.

The prime rate was maybe around 3 percent. For 1961, you had a 1.5 CPI; prime 4.8. 1975, 0.3 CPI; prime 7.9. 1975, 6.9 versus 7.5. Prime rate in 1979, 13.3, 12.6.

CORRELATION BETWEEN INFLATION AND INTEREST RATES

Now, we have got a 9-percent inflation rate and a 20-percent prime interest rate. In response to the last question where you said that the market is not convinced and made reference to the climate vis-a-vis our tax rates, are you suggesting that perhaps we will not see any kind of a correlation in the future between inflation and interest rates? Could you put where we are in a historical perceptive?

So many people, not only in the street, but rather successful financial people, tell me that this is something that is different. It is an aberration, and in their opinion, they are looking for a scapegoat. They are saying it shouldn't happen from a historical perspective.

I have to maybe concur with that. I maybe——

Mr. Volcker. I would be glad to respond. If you look at history, going back as far as I can—and there is a very good study on this that goes back to 1792, I think—what you will find is that there has been a great deal of instability in the real rate of interest throughout that expansive length of history.

It is also true that beginning about 1950 and continuing through the middle of the late seventies, the real rate of interest was pretty steady, and this notion that there should be 2 or 3 percent difference between inflation and interest.

There is good reason for it. You know, over time, the inflation rate should bear a relationship to interest rates. In the past the relationship was much more volatile. The fifties and sixties and seventies were pretty stable economic periods. You didn't have recessions, you didn't have much in the way of inflation during most of that period. You didn't have much change in interest rates. I thought the author of that study put it pretty well in one of his concluding comments. He said, "If there is some law that the real rate of interest must be 2 to 3 percent, Moses must have brought it down from Mount Sinai about 1950."

Apparently, Moses went back up to the mountain in 1970. What I read into this is that there is a lot of instability in the shorter period of time. Of course, when you are looking at charts that go back to 1792, and rates are up for 2 years, that looks like a blip

NEVER HAD THIS KIND OF INFLATION

When you're living through it, it seems like eternity. We have had high real interest rates in the past. Typically when we had inflation, real interest rates were low and even negative. When we had high real interest rates in the past, prices were declining, and that is why the real interest rate was high—not because the nominal interest rate was low, but because prices were declining.

I would suggest to you that a possible explanation as to why it is taking more time to get a realinement as I suggested earlier to Senator Sasser, that we have never had this kind of inflation before in our history, persisting over this many years, at this rate of speed.

Our presumption has always been that we may have inflation for a time, but we will always return to price stability. That was the presumption until fairly recently, until this period. I am afraid what has happened, because inflation has persisted, is that that kind of presumption that we may be having inflation today but it is going to go down in a year or two has been damaged. When people begin changing their expectations in that fundamental way, which they began doing in the late seventies, you see if reflected in the interest rate structure.

That suggests we are going to have to be convincing in policies and see some progress for awhile before we can expect interest rates to return to their old relationships.

This is apart from the tax structure.

Senator **Quayle**. What if we are able to sustain an inflation rate of 9 percent or less for the next 12 months? The word "convincing" is such an arbitrary word I wish we wouldn't even use it, because it seems that no matter what we do we are not convincing enough.

If we continue to have inflation at that level or close to it, is there any other alternative but to have the interest rates come down?

DON'T HOLD INFLATION RATE AT ONE LEVEL

Mr. **Volcker**. I would suggest to you that you set your sights at a rate of inflation lower than 9 percent. I don't know what kind of mood a 9 percent inflation rate—which is possibly where we are now—persisting for a year or two, would leave people in. I think we would now want to make progress in getting to see it down. I don't believe in the stability of the inflation rate; and hold it there nicely at 9 percent, or any other level indefinitely.

We either go backward or forward. In this case, to be convincing, I think we better be going down.

Senator **Quayle**. Let me ask a hypothetical.

If the Congress goes along with the charted path of the administration in fiscal policy and the monetary as you have espoused here today, do you believe the inflation rate will go down?

Mr. **Volcker**. Yes.

Senator **Quayle**. And as the corollary to that, don't interest rates also have to come down?

Mr. **Volcker**. The charted path, of course, includes the budgetary path.

Senator **Quayle**. The charted path that the administration has advocated?

Mr. **Volcker**. Yes.

Senator **Quayle**. That would be the fiscal policy and the monetary policy, notwithstanding with any kind of deviations from the tax policy that the Congress has already passed?

Mr. **Volcker**. If you can meet the expenditure target, I think essentially everything will have been done that is necessary on the financial side. I don't want to minimize the importance of other economic policies that we haven't discussed this morning. I think they are very important.

But far as the financial side is concerned, I think that puts things in place.

Senator **Quayle**. One final question.

REGULATORY REFORM IMPORTANT IN DEALING WITH INFLATION

Is there a regulatory impact on inflation, and if so, how important or unimportant is regulatory reform for dealing with inflation?

It has not been mentioned today.

Mr. **Volcker**. It was mentioned only in passing.

I think it is very important. Obviously a direct impact from reducing those regulations that add to costs or impair innovation in the economy would be very important, which I think people understand. I think equally important, more important really, is to reduce regulations that affect the competition in the economy. You see these in the labor market; you see them in other markets. If you get deregulation of the trucking industry it will have quite a lot to do with the competitiveness of the trucking industry and its wage rates over years.

Take the example of the automobile industry, which is critically important. In the automobile industry, you saw a lot of cost added directly by the regulatory burden. You have regulations in a broader sense—minimum wage laws, government services contracts, all those things—that are putting a floor on costs and pushing costs up. Whatever other merits they may have, I think without question they contribute to inflation.

I think all those things are important and all those things, collectively, is what makes the economy respond relatively slowly to the financial policies we are talking about.

Senator SYMMS. Thank you very much, Mr. Chairman.

You certainly have been very diligent this morning and very persistent. We appreciate your patience.

I just in closing would ask you one last question.

CAN GOALS BE ACHIEVED

To your knowledge of the Federal budgetary process, do you believe that it is possible for us to achieve the stated goals of the administration and the goals that some of us have been advocating for many years, and that is, to achieve sound fiscal policy without having Congress address the very important transfer payment retirement programs?

Mr. VOLCKER. I think you are going to have to examine some of those programs. What I will say to you which I think has been amply reflected in comments around the table, is that I'd like to think you have no alternative but to fact up to those problems.

Senator SYMMS. I appreciate that answer very much.

I do think there really is no recourse as far as the Congress is concerned; they have to get to the basic problem. I think if we look at the budget you see in the fifties talking about history, when industries were more reasonable and the budgetary process was not so out of hand, the Defense Department was consuming well over half of the budget, and turn that around today, we are consuming less than 30 percent of the budget, we have to look at where the other areas are.

I think if the public would get a good understanding of the problem, we would prefer to have less government expenditures and lower interest rates and sound, more stable dollars than they would the other course.

I appreciate your answer.

Do you want to make any last statements?

Mr. VOLCKER. No, thank you very much.

Senator SYMMS. The meeting is adjourned.

Thank you, sir.

[Whereupon, the hearing was adjourned at 1:10 p.m.]

VIEWS OF OUTSIDE ECONOMISTS

WEDNESDAY, SEPTEMBER 16, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 2:20 p.m., in room 6226, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman) presiding.

Present: Senators Domenici and Gorton.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

Chairman DOMENICI. The hearing will please come to order.

Let me apologize to the three of you. The Senate is in session, and I can't promise you this will not keep happening all afternoon.

OPENING STATEMENT OF CHAIRMAN DOMENICI

I would like to begin by welcoming our distinguished guests this afternoon. We look forward to the views of economists from outside Government on the economy and the budget.

Dr. Ronald McKinnon is currently professor of economics at Stanford University and has published extensively on foreign exchange theory and the effect of domestic economic policies on the world economy and the world inflation rate. I look to Dr. McKinnon to add an international dimension to our discussion today.

Next to him is Dr. Allan Meltzer, who has appeared before this committee before. Dr. Meltzer has undertaken consulting assignments with the executive and legislative branches, and, therefore, understands first hand some of the problems that we as policymakers face. Dr. Meltzer is also chairman of the Shadow Open Market Committee which is an informal association of economists who monitor the course of monetary policy and have acted as a devil's advocate for many of the Fed's changes in policies and operations over the years.

Finally, I wish to welcome Dr. James Tobin, who is a old friend to this committee, as he had consented to appear on similar panels several times in the past. We are fortunate to have him again with us today.

As you are aware, this committee is scheduled to mark up the second concurrent budget resolution during the first week of October. Clearly, we begin our work with a sense of urgency about setting specific strategies to fulfill the budget plan we set out last spring. I hope that you will address the conduct of monetary and fiscal policy in your testimony this afternoon and provide us with a better understanding why interest rates in recent months have remained so high. In addition, I hope that you will provide this committee with some guidance regarding the actions it might consider to insure credit markets and the public at large, that the Congress intends to fulfill the letter and the intent of the President's program.

I am pleased to have such a distinguished panel and I look forward to your testimony this afternoon.

We will proceed now to hear from our three witnesses. We will start with you, Dr. McKinnon from Stanford University. Dr. Meltzer and Dr. Tobin can follow in that order.

We have your prepared remarks. We will handle it however you see fit. Your entire remarks, including the attachments thereto, will be made a part of the record.

You can summarize or give the statement, whichever you prefer.

STATEMENT OF RONALD I. McKINNON, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Dr. McKinnon. Thank you, Senator.

Instead of reading my paper, I will make some summary comments on it. My assignment by the committee is to bring international considerations to the debate we have had on American budgetary and monetary policies. After sitting through the testimony yesterday of Dr. Alice Rivlin on the fiscal side, I heard the word international mentioned just once, and that was peripheral to her main arguments regarding the U.S. budget. Throughout the very exciting testimony of Paul Volcker on U.S. monetary control this morning, again the word international was hardly mentioned.

Yet I believe that by appealing to certain international considerations, the puzzle of why interest rates should be so high at present can be substantially explained. The state of the international economy is now more important for the United States than it was 20 years ago.

Monetary policy today is unduly tight and causing a liquidity squeeze, but the nature of the squeeze cannot be seen if we refer only to American monetary aggregates. Instead, it is necessary to look at some concept of the world money supply in relation to the behavior of the dollar in the foreign exchange markets. This is the main theme of my accompanying written submission to the committee.

But before getting into the technical details of monetary policy, I would like to say something about the budgetary deficit and fiscal policy which is not in my prepared statement.

DEFICIT IS 2 TO 3 PERCENT OF GNP

If the U.S. deficit is realistically projected into 1982, most estimates seem to be about $60 to $80 billion. These are about 2 to 3 percent of American GNP for 1982. By past standards, this is a substantial Government drawing on private saving—but something that has been done quite easily before. The United States handled deficits of that magnitude in occasional years in the sixties and early and middle seventies.

However, in the sixties and early seventies other industrial countries in Europe and Japan tended to run with small Government deficits or with surpluses. So when the U.S. Government ran a substantial fiscal deficit as it did, say, during the Vietnam period, it was quite possible to finance a big chunk of this by selling bonds net to foreigners by running a commensurate deficit in the current account of the U.S. balance of payments.

This means of finance, then, prevented a financial squeeze in the American money market.

Chairman DOMENICI. Doctor, you said it was quite possible, but did it happen? Did we do it that way?

Dr. MCKINNON. Yes; while the sizes of our Federal fiscal deficit and our trade deficit are variable through time, in several years in the late sixties and early seventies, that was an important mode of Government finance for the United States. This perception is not in everybody's consciousness at the present times but that is the way it turned out historically.

INDUSTRIAL COUNTRIES COMBINED DEFICITS DOUBLED

Now, however, the situation has changed within the industrial world. According to the most recent IMF statistics that are in front of me, the combined deficits of all the industrial countries have virtually doubled in 1979, 1980, and 1981 compared to what they were back in the early seventies. Japan, which used to have a fiscal surplus, is now running a large fiscal deficit. European governments that used to have small deficits now have big ones.

In the full employment year of 1973, the average government deficit of all the industrial countries was 4.87 percent of expenditures, whereas in 1979, which is more or less a comparable year regarding full employment, the average deficit had risen to 9.79 percent of expenditures. On average, that is an increase from 2 percent to 5 percent of GNP.

Surprisingly, the position of the United States has not changed that much. Back in the early seventies, we, too, ran Government deficits that were of the order of 2 percent of GNP, and that is about the order of magnitude projected for 1982. But now foreigners can no longer easily be relied on to help us with its financing. As Paul Volcker outlined this morning, we are necessarily more dependent on our own rather narrow savings resources.

Because of this changed international situation, the United States cannot appeal to its own past history and say, "Well, in 1973, we ran a deficit of 2 or 3 percent of GNP and that was handled easily." In fact, at present we will have a great deal more trouble financing a Government deficit of that magnitude by trying to sell bonds to foreigners. They, in fact, will demand a much higher real rate of interest because their own deficits now are preempting the flow of saving in the international economy. That is my main point on the fiscal side.

But there is another important consequence of relying on foreign finance. If the United States lets a large deficit run and, as in the past, tries to tap the saving of foreigners to help finance that deficit, American authorities must be prepared to see the current account of the balance of payments go into deficit. The means by which, say, the Japanese help finance the U.S. fiscal deficit is by running a surplus on the current account of the balance of payments and then using that surplus in the flow of goods and services to purchase American securities.

One way out of this fiscal bind, therefore, will come naturally in the exchange markets with the appreciation of the dollar as securities are sold to foreigners and the current account slips into deficit. By thus drawing on the saving of foreigners, interest rates in this country would remain somewhat lower than otherwise.

CURRENT ACCOUNT DEFICIT IS SAFETY VALVE

We should now recognize that a current account deficit as a means of public sector finance for this country is an important safety valve in the system. Therefore, it really makes no sense to send people like Mr. Brock to Japan to hector the Japanese regarding their current account surplus which is merely the counterpart of our current account deficit that, in turn, is a natural consequence of the U.S. Government's fiscal deficit. The Japanese surplus is very useful at this juncture in keeping the lid on American interest rates because the Japanese will be buying some of the Treasury bonds and bills that would otherwise have to be marketed domestically. Rather than complain to the Japanese, we should simply accept a current account deficit as a natural adjunct to the projected American fiscal deficit. An unfortunate consequence of this mode of public finance is that American industries that must compete in world markets will find the real exchange rate turned against them.

Well, that is what I wanted to say on fiscal policy, just to give a little international perspective. In summary, over the last 10 years there has been a change from adequate saving to a shortage of saving in the industrial world. I am taking the un-Keynesian view that this will be a restraint on future growth. The United States cannot easily tap that savings pool like it used to, and if it does try, it must be prepared run a fairly large current account deficit. But the results will still be higher interest rates, even in this latter case, than what the United States has experienced in the past.

AT TIMES BIG PART OF TREASURY BONDS AND BILLS BOUGHT BY FOREIGNERS

Chairman DOMENICI. Doctor, let me just say this. What you have just said sounds very logical. I do not know the other effects of running a deficit in the balance of trade. But let me ask you. Are you certain that there was more money being invested in the era that you described by foreign investors, not just typically free industrial nations, just foreign investors, including cartel countries, Saudis, the others? Are you sure there was more invested in that era you speak of than is being invested now?

And if not, does that not sort of destroy the premise?

Dr. MCKINNON. The size of our fiscal deficit, as you know, has varied a great deal with the business cycle and with the needs of war finance and so forth, and so has the U.S. trade surplus or deficit been variable. But there have been years in the seventies, Senator, where most new Treasury bonds and bills issued net by the U.S. Government had been purchased by foreigners, largely foreign central banks.

Chairman DOMENICI. If anyone is going to argue your premise, you are basically urging that we do whatever is necessary to encourage a significant portion of the world supply of dollars or their counterpart, to be invested in America.

It would appear to me that that makes sense, but you base the validity of that as having an effect on our interest rates on a proposition that we used to get a bigger share of what we need from that source than we are now.

And my question is very direct. I do not know that you know the answer. If you do, I would appreciate it. I hear about significant foreign investment in America today, not necessarily related to balance of trade deficits, and I would assume there is no difference between Saudi dollars invested here in buying our Treasury notes with or without a balance of trade deficit. That is the kind of money you are talking about, is it not? Whether it is from them or the Japanese who used to or the Germans, and I just want to know: Do you know that there is less invested now relatively speaking than there was then?

TWO WAYS CAPITAL FLOWS IN

Dr. McKinnon. There are two ways capital flows in on private account. What you mentioned is one channel. Foreign multinationals invest in the United States, as do private foreign individuals from OPEC and elsewhere. Some of it comes through purchases of U.S. bonds or "equities" and some may be channeled through the Eurocurrency markets and the banking system. Then from time to time, there has been massive foreign government investment, mainly in U.S. Treasury bonds and bills, in this country. One of those times was in 1971 and 1972 before the breakdown of fixed exchange rates and at the high point of U.S. war finance. Another time, surprisingly, was 1977-78. During both these periods, foreign government financed a high proportion of the new Treasury bonds and bills that were issued by the U.S. Government. For there to be a net capital inflow across both private and official channels, however, there must be a current account deficit in the balance of payments.

Chairman Domenici. The reason I raise the question—I hear West Germans complaining bitterly about our high interest causing such of their resource; namely, dollars or dollar value—I hear the Chancellor over there saying it is coming to America. I do not know whether that is true or not. That is kind of related to what you are talking about.

Dr. McKinnon. This is a good point, because they are running a much bigger public sector deficit than they used to. Ours is about the same size as it has been in the past. So they are going to complain a great deal more than before about the pressure to help finance the American deficit.

MONETARY POLICY

Now, I would like to switch to monetary policy. Again by appealing to international considerations one can understand better why we have had in 1981 an unusual liquidity squeeze in the American money markets that has made interest rates even higher than that made necessary by the projected fiscal deficit. Moreover, this unnecessarily sharp squeeze imposes an undue risk of a substantial cyclical downturn on the U.S. economy and those of its trading partners.

My basic thesis is that in an integrated world economy it is becoming increasingly inefficient to look only at national monetary aggregates as explanations of national rates of inflation. The moneys of an inner group of convertible-currency countries are becoming more substitutable in demand. Deutsche marks are more substitutable with dollars, and yen with dollars, than they used to be. The demand in the international money markets for any one of them tends to be less stable—even though the demand for the group may be relatively stable. Thus, only when the aggregate money supply for the group of convertible-currency countries is considered, do you get a good explanation of international inflation and deflation. The U.S. money supply growth by itself cannot explain cyclical movements in the American price level.

To make my talk as brief as possible, perhaps those of you who have access to the paper could look at the tables, beginning at table 1 on page 120. They contain what I think are some fairly interesting data. Consider M_1, or its equivalent according to the International Monetary Fund statistics, across the 10 industrial countries in table 1.

If you look at U.S. M_1 from 1960 to 1980, there is relatively little variance in its rate of growth. I know that from quarter to quarter of from month to month there has been a lot of variance in money growth measured on an annual basis. However, when one compares one year to the next, there has been relatively little variance in the American money supply statistics.

But that has not been true for growth in the money supplies of other countries like Japan and Germany, and especially Switzerland. They have been subject to terrific ups and downs, and these pronounced year-to-year fluctuations can be related to speculation in the foreign exchange market.

FIRST GREAT LOSS OF MONETARY CONTROL

The first great loss of monetary control in the world system took place in 1971-72 when everyone speculated on the breakdown of the Bretton Woods system of fixed exchange rates. At that time, there was a terrific capital outflow from the United States, associated with a fall in the demand for dollars and a rise in the demand for foreign currencies. Foreign central banks then intervened to prevent the dollar from depreciating as fast as it otherwise would. They bought dollars, built up their dollar exchange reserves, and sold their own currency; and thus table 1 shows a large increase in foreign money supplies. The United States behaved as if it was on a national monetarist rule and did not contract in an offseting fashion. You can see for 1971 and 1972 that U.S. money growth was a moderate 6 or 7 percent per year. But looking at the aggregate money growth for the group, which is the right-hand column in table 1, we see a sharp increase in the world money supply in 1971-72.

The same thing happened in 1977-78 with the "Blumenthal" devaluation where the dollar was talked down against the yen and other currencies. Again strong speculation against the dollar resulted in a fall in the demand for dollars, a capital outflow, and a sharp rise in other countries' money supplies. Again the world money supply increased sharply above its trend.

WORLD MONEY SUPPLY EXPLAINS TWO GREAT INFLATIONS

Now, both these losses of monetary control were not reflected in American money supply statistics, but they were followed by the price explosions portrayed in table 2 on page 121. If you look at wholesale prices for the 10 industrial countries—I'm trying to approximate a representative basket of tradable goods so I am putting aside consumer prices—you can see that the loss of monetary control in 1971–72 was followed by by an inflationary explosion in 1973–74. Then we have another quiescent period with the loss of monetary control in 1977–78 followed by the inflationary explosion in 1979–80. So the two great inflations of the seventies, I submit, can be explained by looking at the world money supply. One cannot get much out of U.S. M_1 as an explanation although the U.S. price level rose sharply in both episodes.

Table 3, which is on page 122, simply gives the sources of the loss of monetary control in these two periods: The big run up of exchange reserves in 1971–72 and 1977–78 by foreign central banks as they intervened to prevent the dollar from depreciating even more precipitiously.

With that history behind us, let us now use the same model to analyze the current situation. Please turn to table 4 on page 123.

The two inflationary episodes of the seventies were associated with speculation against the dollar and an increase in the world money supply as the dollar depreciated in the foreign exchanges. I would argue now that in 1981 we are in the deflation phase of this international cycle associated with speculation in favor of the dollar and a sharp slowdown in world money growth. To some extent the way this arose was accidental. We had the election of a new government in the United States that appeared, to all reasonable observers, to be more committed to reducing price inflation in the future. Hence dollars immediately became more attractive in international asset portfolios. In addition, there were adverse political events in Europe: the invasion threat in Poland and the change to a socialist government in France with some expropriation of property and exchange controls. We have thus a push and a pull: a surge out of European currencies, and to a lesser extent from the Japanese yen, into U.S. dollars.

TIGHT MONEY RESULT OF SUPPLY AND DEMAND

Thus did the demand for dollars increase in 1981. But the Federal Reserve System is committed to a fixed national monetarist growth rule so it refused to increase the supply to accommodate this surge in demand. The result is very tight money in the United States that is manifested in high short-term rates of interest and the sharp bidding up of the dollar in the foreign exchange markets.

To portray the slowdown in world money growth, consider the money supply data in table 4 for the United States, Germany, and Japan in 1980–81. There is no seasonal adjustment and there is no adjustment for NOW accounts or automatic transfer accounts. Thus the rate of growth in M_{1B} for the United States looks higher than the adjusted numbers, considerably higher. But if one were to make the adjustment for NOW accounts and ATS accounts for the American data what I have shown as an annual rate of growth from June 1980 to June 1981 of 8.6 percent would be the order of 5 percent.

From Chairman Volcker's testimony this morning, the U.S. money aggregates seem to be tracking their long-term paths more or less correctly if you look just at national data. Growth in M_2 is a bit high. That in M_{1B} is a bit low after adjustment, but the American money aggregates by themselves do not appear out of line.

FOREIGN EXCHANGES SENDING CLEAR SIGNAL

However the foreign exchanges are sending very clear signals that American monetary policy is too tight in 1981. The first was the appreciation of the dollar which is itself indicative of tightness.

The second is that the other two important competing moneys in the system are growing too slowly. The German and Japanese central banks have been forced into the exchange market to prevent their currencies from depreciating more rapidly. They have sold off their dollar reserves in order to buy back their own currencies. This forces their money growth significantly below long-term trends. In table 4, German money growth from June 1980 to June 1981 is just 2.3 percent

For Japan, the numbers jump around a lot and one should not put much stock in any one annual comparison. Nevertheless, money growth of 4.6 percent from June 1980 to June 1981 also seems low. You must remember that Japan is naturally a very high growth economy. Nominal GNP in the seventies has grown at the order of 12 percent per year. Some of that has been inflation so they would not want it to grow that fast in the future, but nevertheless, the money growth of 4.6 percent for a narrow M_1 in Japan is also below its long-term trend according to any good purely national monetarist principle.

Suppose we consider these three currencies in table 4 as a group which more or less defines the world money supply. Then growth in world money is far below any desirable long-term trend. The result is unduly tight money on a world-wide scale at the present time.

START PAYING ATTENTION TO MONEY SUPPLY

From looking at the two great inflations of the seventies which we could not see with American monetary statistics, and the big deflation now which we cannot see in American monetary statistics, we should start paying attention to the money supply of these three countries in formulating American monetary policy. The Fed should be willing to adjust its money supply to accommodate friendly interventions on the part of Germany and Japan so as to stabilize money growth for the group much better.

Presently this would mean that the Fed would expand somewhat faster. Its M_{1B} would rise somewhat above its own target as a method of increasing the money supply for the group. If in 1981 we had been on the regime outlined in my written submission, when the Bundesbank intervened to prevent the mark from falling and the dollar from rising, the resulting monetary contraction in Germany would have been automatically offset by a symmetrical expansion in the United States. The aggregate money supply would not have fallen below its trend and undue world deflation would have been avoided.

For the longer term, the three countries should mutually adjust their monetary and exchange rate policies to stabilize money growth for the group according to good monetarist principles that Prof. Allan Meltzer will undoubtedly give you in his paper. The key idea is to define the relevant money supply on an international, rather than on a national, level. Then I think the U.S. financial system itself would become much more stable apart from considerable benefits accruing to the rest of the world.

Chairman DOMENICI. Thank you very much, Dr. McKinnon.

PREPARED STATEMENT OF RONALD I. McKINNON, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

THE FOREIGN EXCHANGES, GOLD, AND MONETARY CONTROL IN THE UNITED STATES

Should foreign-exchange considerations or observed growth in the money supplies of other industrial countries significantly influence the domestic monetary policy of the United States? The received wisdom of both monetarist and Keynesian economists and the revealed preferences of United States policy makers has been to try--often unsuccessfully--either to suppress international influences or to ignore them. Both groups define policy targets in terms of growth rates in purely domestic monetary aggregates, or in terms of domestic (dollar) rates of interest.

Although possibly appropriate during the "strong" dollar standard of the 1950s and early 1960s, such insular monetary decision making has contributed to the severe exchange-rate and price-level instability experienced by the United States and her trading partners in the 1970s and 1980s. The unfortunate outbreaks of international inflation in 1973-74 and again in 1979-80 can, in large measure, be attributed to unduly expansive American monetary policy in 1971-72 and again in 1977-78. But this undue expansiveness was not unambiguously reflected in the relatively modest rates of monetary growth in American monetary aggregates either in 1971-72 or in 1977-78. In these same two episodes, rates of interest in the U.S. money markets were even more ambiguous in indicating whether or not the Federal Reserve's policy was too inflationary. However, the severe pressure in the foreign exchange markets leading to sharp dollar depreciation in both periods, and unusually rapid growth in the relevant "world" money supply (to be defined below), should have signalled the Federal Reserve Board that U.S. monetary policy was too easy.

In the technical research paper "Currency Substitution and Instability in the World Dollar Standard" (August, 1981), I present a more detailed statistical analysis of money growth and price-level behavior within an inner group of the ten principal industrial countries from 1960 to 1980. Here simply note from Table 1 that the money supply for the group is more variable than is the U.S. money supply by itself. Moreover, the group's money supply increased sharply in 1971-72, when speculation against the dollar anticipated the break down of fixed exchange rates under Bretton Woods. The group's money supply increased sharply again in 1977-78 with renewed speculation against the dollar early in 1977, after officials in the Carter administration had opined that the dollar was "overvalued". This speculation didn't end until the massive stabilization program of November 1st, 1978. That these sharp increases in the money supplies of industrial countries other than the United States were due to heavy foreign exchange intervention to prop up the dollar is confirmed by Table 3 showing the sharp build up of dollar exchange reserves in 1971-72 and again in 1977-78 by foreign central banks. Finally, Table 2 shows the two international price explosions in 1973-74 and 1979-80 that followed the losses of control over the group's money stock in 1971-72 and 1977-78.

Note that the United States shared fully in both price level explosions (Table 2) due to these international losses of monetary control. In effect, this *ad hoc* measure of the world money supply (Table 1) predicts the cycles in American price inflation much better than does any domestic American monetary aggregate such as M1 or MIB.

At the present time, we are now on the *deflation* phase of the international cycle. American monetary aggregates, by themselves, indicate moderate growth "close to" the Federal Reserve Board's targets--see measures of MIB in Table 4. Rates of interest in the United States financial markets are completely clouded as monetary indicators because of uncertainty over the size of the federal government's deficit and the recent radical tax and regulatory changes in the treatment of various classes of bank deposits and other securities. However, the foreign exchange markets are sending the American authorities the clear signal that U.S. monetary policy is too "tight". In 1981, the dollar has appreciated sharply against the stable-valued currencies of important trading partners such as Germany and Japan. (Dollar appreciation against the French franc or Italian lire--neither of which is stable valued--can be safely disregarded. The intensification of exchange controls in both France and Italy, along with higher levels of inflation, eliminates their currencies as alternative sources of international liquidity in the 1980s).

This sharp appreciation of the dollar in late 1980 and so far in 1981 reflects increased international demand for dollars with no compensating increase in their supply. With the election of the Reagan government and the institution of an apparently much tougher monetary stance--lower acceptable inflation guidelines for the future with the Federal Reserve System given a freer hand to achieve it--dollars have recently become more attractive relative to yen, deutche marks, and other relatively stable valued European currencies. Moreover, increased political and economic uncertainty in Europe, arising out of recent events in Poland and in France, makes holding liquid funds in Europe look less safe. The resulting inflow of private capital to the United States, some of it being merely a reflux from what flowed out in 1977-78, reflects increased demand for a whole spectrum of short-run dollar assets: MIB, certificates of deposit, bills, etc. From this arises an increased derived demand for base money--currency and bank reserves--from the Fed. Because the Fed has committed itself to a purely national monetary growth rule, however, it dares not to expand the supply of U.S. base money commensurately with the increased (international) demand for it--unlike what more traditional principles of monetary and foreign exchange management might suggest.

The result is unduly "tight" money in the U.S. at the present time that is reflected both in exchange appreciation and in ordinately high short-term interest rates. Widespread concern for a large government deficit in the future is an important reason for the extraordinary increase in longer term interest rates in the United States.[1] Nevertheless, I believe that the liquidity squeeze arising from these international monetary considerations is an important contributing factor in making longer term interest rates even higher.

To prevent their own currencies from depreciating too sharply against the dollar, in 1981 other governments have intervened to repurchase their own currencies by drawing down their dollar exchange reserves. This has the effect of retiring their base money from circulation, and forcing their rate of monetary growth significantly below long term trends. Table 4 presents raw (not seasonally adjusted data) on narrow (M1) money supplies in the United States, Germany and Japan for 1980 and 1981. This monetary data fluctuates a great deal, and one cannot put much weight on any single year-to-year comparison. For the latest comparable data from June 1980 to June 1981, however, we see U.S. money growth is 8.6%, Germany's is 2.3% and Japan's is 4.6%. By a purely national standard, U.S. money growth might be considered moderate given the officially projected growth in nominal U.S. GNP and the fact that M1B is not adjusted downwards for the spread of newly authorized "NOW" accounts. But German money growth looks very low.

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[1] Although Americans are (correctly) focussing on the size of their own government deficit, note that the collective government deficit of all the industrial countries is now twice as high as it was in the early 1970s (IMF Survey, September 7, 1981, pp. 261-276). European governments are running much bigger deficits, and there has been a big swing from surplus to deficit in Japan. Hence, to reduce pressure in long term interest rates, the U.S. government must reduce its deficit quite drastically--perhaps even running a surplus--relative to its own past experience.

Moreover, given the historically much higher real growth in Japan, its current money growth looks even more on the low side. From 1970 to 1980, the rates of nominal GNP growth were 11% per year for the U.S., 8.3% for Germany, and 12.4% for Japan.

What general conclusions for the ease or tightness of the "world" money market might we draw from these statistics? Just as purely U.S. monetary aggregates understated the degree of inflationary pressure in the world economy in the 1970s when there was heavy speculation against the dollar, so now in 1981 does American M1B underestimate the degree of deflationary pressure in the system when there is speculation in favor of the dollar. The relevant "world" money supply--combining that of the U.S., Japan and Germany (possibly including some of the smaller European countries with stable-valued monies)--is now growing too slowly. And, from the experience of the 1970s, this tentative measure of the world money supply is a better predictor of inflationary or deflationary pressure in the United States itself than is any purely American monetary aggregate.

My argument implies that the U.S. government has erred in imposing a purely national money growth rule on the Federal Reserve System--and this has resulted in undue deflationary pressure at the present time. However, we do need a well-defined monetary standard. The monetarists are quite correct in arguing that purely ad hoc decision making on the part of the central bank destabilizes expectations and could well lead to greater financial turmoil. My tentative solution is simply to lift the argument for controlling growth in "the" money supply from a national to a carefully defined international level. The Fed should give events in the foreign exchanges substantial weight in formulating American monetary policy, and a systematic procedure for doing so is taken up next.

Monetary Cooperation with Germany and Japan

My basic thesis is that monetary management in the United States should be oriented towards:

1) Securing greater exchange-rate stability with America's principal trading partners--mainly Germany[1] and Japan--through mutual adjustment of monetary policies to support stabilizing official exchange intervention, usually undertaken by the Bundesbank or the Bank of Japan; and

(2) Ensuring control over, and a smooth rate of growth in, the aggregate supply of dollars, yen, and deutsche marks that now collectively constitute "world" money for all practical purposes.

The rationale for this more internationalist approach, requiring coordinated monetary policies among these three countries, is straightforward. First, the triumvirate is becoming increasingly integrated financially across eurocurrency and domestic money markets as far as their own citizens are concerned. For individuals, firms and governments in the rest of the world, deutsche mark and yen assets are gaining status with dollar assets as acceptable international stores of liquidity or official exchange reserves. For quite some time, the deutsche mark has been increasingly used to denominate commodity trade, eurodeposits, and new international bond issues. More recently in 1979-80, Japan has undertaken a sweeping financial liberalization in which domestic rates of interest have been freed and exchange controls have been largely abolished. With its recent good record of maintaining stable real purchasing power, the yen is now providing yet a third international store of value for both governments and firms elsewhere. Of course, the dollar still remains the most important currency for denominating reserve assets held by governments--whose interventions in the foreign exchanges are almost exclusively in dollars.

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[1] Possibly including a cluster of small economies around Germany with stable and convertible currencies. However, the whole European Monetary System (EMS) is not a suitable reference point insofar as it includes high inflation countries that protect their currencies with exchange controls. The case for greater exchange rate stability is made in more technical detail in the author's "The Exchange Rate and Macroeconomic Policy: Changing Postwar Perceptions", The Journal of Economic Literature, June 1981, pp. 531-557.

Why should these (desirable) institutional changes now require a common monetary policy and stable exchange rates across the three countries? Because the three monies now have a high degree of subtstitutability in demand in international portfolios, persistent exchange rate movements in one direction or another may well induce enormous private capital flows toward the "strong" currency and thus become self-sustaining. In effect, the presence of alternative internationally usable monies (in the sense of largely non-interest bearing M1) makes the demand for any one of them potentially unstable in response to expected exchange-rate movements--or in response to random political events in various parts of the world. This international currency substitution seriously undermines the case for a purely national monetary growth rule, accompanied by freely floating exchange rates, that implicitly presumes that the demand for the national money is largely immune to cyclical international influences.

On the positive side, the evidence on international inflation and deflation cited above suggests that the demand for "world" money--that collectively provided by an inner group of convertible currency countries--is relatively stable. This aggregate money supply seems to predict international business cycles reasonably well. Hence, coordinated policy to smooth the aggregate rate of monetary growth of the triumvirate is in the interest of each of the three countries--as well as the rest of the world.

In this new regime, the Federal Reserve System would have to continually adjust its short-run rate of monetary growth to support "friendly" foreign exchange interventions by Germany and Japan. (However, the Fed would continue to ignore exchange interventions by the other 138 members of the International Monetary Fund whose currencies do not compete with the dollar as an international store of value). If the new regime had been in place in 1981, for example, the Bundesbank would have intervened earlier and more determinedly to prevent the dollar from appreciating discretely. As the Bundesbank sold dollars (from its exchange reserves) and repurchased deutsche marks, the Fed would allow those newly injected dollars to increase the U.S. money supply above its trend to offset the fall in the Germany money supply below its trend

(Table 4). Not only would the DM/dollar exchange rate be more stable, but the unfortunate slowdown in the growth of the "world" money supply in 1981 would have been avoided. Needless to say, the Fed could (should) have reacted the same way to exchange rate smoothing by the Bank of Japan if it were not hampered by a myopic commitment to a fixed rate of growth in M1B or M2 defined only in national terms.[1]

These mutually offsetting national monetary adjustments, in response to stabilizing foreign exchange interventions, would automatically smooth the rate of growth in the relevant "world" money supply.[2] But more is required to ensure that the collective money supply of the triumvirate grows at a predetermined rate that can easily be ascertained by the financial community. Indeed, a major objective of a well-publicized international monetary pact is to downgrade the importance of (random) weekly changes in the money supply of any one country; and focus instead on each government's commitment to exchange-rate stability within a moderate range--and on the progress of the money supply for the group.

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[1] A more detailed technical analysis of precisely how such official interventions would work is provided in my "Currency Substitution and Instability in the World Dollar Standard", (forthcoming) American Economic Review, June 1982, and in "A New Tripartite Monetary Agreement or a Limping Dollar Standard?", Princeton Essays in International Finance, No. 106, October 1974.

[2] To take two other examples, in 1971-72 and 1977-78, money growth in the rest of the world increased sharply because foreign central banks were frantically buying dollars and selling their own currencies. If the Fed had responded by retiring these dollars from circulation, allowing the U.S. money supply to fall sharply below its trend, the inflationary explosions of 1973-74 and 1979-80 would have been mitigated.

The sources of money creation from domestic credit expansion on the part of each of three central banks must be carefully tied down. As a first approximation, I have suggested[1] that domestic money growth be assigned to each country according to its historical growth in (non-inflationary) GNP. For example, money growth from domestic credit expansion--approximately adjusted for regulatory changes--could be assigned at 5% per year for the United States and Germany, and at 9% for Japan which seems to exhibit persistently higher saving and real growth based on it. These numbers are purely illustrative and assume we are starting from non-inflationary growth equilibria which are then sustainable through time. (Re-entry from a much higher rate of price inflation might call for a transition period where the collective money supply and nominal GNP were allowed to grow somewhat faster).

Under such a formal agreement, an international monetary standard could be imposed that both smoothed the world business cycle and provided greater exchange-rate stability for enhancing efficiency of international commodity trade. Growth in the aggregate money supply for the triumvirate would be predictable, but random variations in international demand would occasionally move growth in any one of the three national money supplies above or below its long term trend. Even in the absence of such a formal agreement, the Federal Reserve System could pay more systematic attention to events in the foreign exchange market.

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[1] "A New Tripartite Monetary Agreement....", op.cit. Domestic credit means that part of the monetary base not associated with foreign exchange intervention. This construct does not now appear in the U.S. financial accounts, but would not be difficult to calculate.

The Gold Illusion

In considering the plan for monetary cooperation among the United States, Germany and Japan, readers will immediately detect many of the elements of the classical pre-1914 gold standard: exchange rates are stabilized and short-run changes in national money supplies are subordinated to the balance of payments. Within the triumvirate only, a "deficit" country allows its money growth to fall below trend, whereas a surplus country would allow its money growth--from domestic credit expansion plus foreign exchange intervention--to grow above its trend. Not only does each national money supply track the demand for it better in the short run, but the risks facing importers and exporters are reduced as the international purchasing power of each national money is made more stable.

While incorporating these advantages, the proposed agreement avoids the manifest disadvantages of an actual international gold standard:

(1) Inability to match the long-run rate of growth in the demand for world money with a supply dependent on fortuitous gold mining discoveries, changes in technologies for either extracting gold or synthesizing it, and dependence on (potentially unfriendly) foreign suppliers--e.g. Russia and the Union of South Africa--who themselves are not bound by the rules of the gold-standard game; and

(2) The recurrent liquidity crises associated with a system of fractional reserve banking--when from time to time on a global scale individuals and firms may wish to convert paper or deposit money into gold coin or gold bullion--the short-run supply of which is inelastic; and

(3) The real resources costs of digging gold out of the ground in some parts of the world, and then burying it with all due security precautions elsewhere.

The monetary cooperation pact outlined above avoids these three disadvantages. Long-run growth in the supply of the relevant "world" money is carefully controlled to match long-run demand--with the assistance of two friendly trading partners with a better recent record of price-level stability than the United States. Potential liquidity crises, where demand shifts from M1 or M2 towards central bank base money, would be automatically offset because the three central banks were committed to a smooth rate of growth in, say, M1.

The still valid objections , (1), (2) and (3), to the gold standard are well known. What is really surprising about current American proposals to restore the gold standard, however, is that apparently the United States is to act unilaterally. One day the U.S. Treasury is to announce that gold will be bought or sold for, say, $400 per ounce (or perhaps $35) and the Federal Reserve System will adjust the supply of bank reserves and currency up or down by the amount of these transactions irrespective of what is going on in the rest of the world. Because stable exchange relationships with other countries are not being considered directly, any gold price chosen will be essentially arbitrary: either too high and it all flows into the United States, or too low and it all flows out. This course of action seems guaranteed to garner for the United States all the disadvantages of a gold standard with a proclivity for financial panics, and none of the advantages in the form of more stable international exchange relationships.

Rather than hoping implicitly that an American return to a gold standard will eventually induce other nations back, far better to recognize directly the pressing need for mutual monetary adjustment among the United States, Germany and Japan and negotiate accordingly. Then the redundancy of the gold standard proposal becomes clear.

Table 1. World Money Supply Increases: Ten Industrial Countries

(In percentage changes between year-end stocks)

	U.S.	CANA	JAPA	U.K.	GERM	FRAN	ITAL	NETH	BELG	SWIT	Weighted World Average
(GNP weights 1970)	(.5274)	(.0432)	(.1042)	(.0548)	(.0989)	(.0304)	(.0491)	(.0167)	(.0137)	(.0115)	
1960	.1	4.0	15.0	.4	6.8	14.1	13.6	6.7	1.9	5.0[1]	4.48
1961	3.3	12.7	18.4	2.0	14.8	15.5	16.0	7.7	7.7	15.3	8.21
1962	2.5	4.3	16.6	3.0[1]	6.6	-18.1	17.6	7.5	7.2	11.3	6.73
1963	3.2	7.3	34.6	3.0	7.2	14.5	13.6	9.3	9.6	7.3	8.69
1964	4.9	9.4	13.0	3.2	8.8	8.3	7.8	8.0	6.6	7.7	6.74
1965	4.8	14.3	18.2	3.9	7.1	9.4	16.1	10.0	7.1	3.8	7.81
1966	2.2	7.3	13.9	0.0	2.3	7.8	13.3	6.8	6.6	3.8	4.66
1967	7.5	10.0[1]	14.1	7.6	10.0	4.8	15.7	6.2	3.2	7.4	8.65
1968	8.0	10.0[1]	13.3	4.1	8.3	8.0	11.9	11.4	7.4	12.4	8.72
1969	3.5	10.0[1]	20.6	0.0	6.0	8.0[1]	15.9	8.1	2.3	11.7	6.71
1970	5.3	10.0[1]	16.8	9.3	9.6	11.1	27.4	11.8	8.3	11.0	9.15
1971	6.1	10.0[1]	29.7	15.2	12.8	11.8	19.0	15.0	11.1	17.7	11.42
1972	7.6	10.6	24.7	14.0	13.9	14.9	24.1	17.6	14.0	5.4	12.17
1973	7.3	5.5	16.8	5.1	0.8	9.8	17.6	0.0	8.8	0.0	7.95
1974	3.0	1.7	11.5	10.8	12.2	15.2	9.4	12.2	6.2	-3.6	6.65
1975	4.6	18.7	11.1	18.6	13.8	12.6	13.4	19.7	15.7	4.2	9.18
1976	5.7	1.9	12.5	11.3	3.3	7.5	18.8	6.8	7.0	10.5	7.22
1977	8.8	10.4	8.2	21.5	12.7	11.1	21.4	14.1	8.3	0.6	10.81
1978	7.3	7.0	13.4	16.4	14.0	11.1	26.6	4.1	5.9	19.7	10.49
1979	6.0	1.4	3.0	9.1	2.0	11.7	23.7	2.8	2.5	-1.3	6.44
1980	3.6	10.7	-2.1	3.9	4.1	6.4	11.5	6.0	0.3	-0.5	3.94

Source: All data are noninterest-bearing M_1 and are taken from line 34 of the International Financial Statistics (various issues) of the International Monetary Fund.

[1] Implies a discontinuous series where arbitrary averaging was used.

Table 2. World Price Inflation: Ten Industrial Countries

(In percentage changes from past year's period average)

	U.S.	CANA	JAPA	U.K.	GERM	FRAN	ITAL	NETH	BELG	SWIT	Weighted World Average
(GNP weights 1970)	(.5274)	(.0432)	(.1042)	(.0548)	(.0989)	(.0804)	(.0491)	(.0167)	(.0137)	(.0115)	
1960	0.1	0.1	0.1	1.3 1/	1.1	3.6 3/	0.9	-2.5 4/	1.1	0.6 4/	0.6
1961	-0.4	1.1	0.1	3.8	1.5	3.0	0.1	-1.2	-0.1	0.2	.5
1962	0.2	2.8	-1.6	2.1	3.5	0.5	3.1	1.2	0.7	3.5	.7
1963	-0.4	1.9	1.7	1.2	0.4	2.8	5.3	2.5	2.5	3.8	.8
1964	0.2	0.4	0.2	2.9	1.1	3.6	3.2	6.2	4.7	1.3	1.1
1965	1.3	2.1	0.7	3.7	2.4	0.7	1.6	3.5	1.0	0.5	1.5
1966	3.3	3.5	2.4	2.8	1.8	2.7	1.6	4.5	0.6	1.9	2.9
1967	.2	1.8	1.8	1.2	-1.0	-0.9	-0.1	0.0	0.0	0.3	.3
1968	2.4	2.2	0.9	3.9	-0.7	1.7	0.3	1.1	1.2	0.1	1.5
1969	4.0	4.7	2.1	3.4	1.8	10.7	3.9	0.0	3.4	2.9	4.0
1970	3.6	1.4	3.6	7.1	4.9	7.5	7.3	6.4	6.0	4.1	4.4
1971	3.3	1.2	-0.8	9.0	4.3	2.1	3.4	1.0	1.9	2.2	3.1
1972	4.5	7.0	0.8	5.3	2.6	4.6	4.1	4.0	4.1	3.6	4.1
1973	13.1	21.5	15.9	7.3	6.6	14.7	17.0	12.4	7.4	10.7	12.9
1974	18.9	22.1	31.3	23.4	13.4	29.2	40.7	13.6	20.1	16.2	21.9
1975	9.2	6.7	3.0	24.1	4.7	-6.1	8.5	7.5 5/	4.5	-2.3	7.5
1976	4.6	5.1 1/	5.0	17.3	3.7 2/	7.4	23.8	7.8	7.1	-0.7	6.6
1977	6.1	7.9	1.9	19.8	2.7	5.6	16.6	5.8	2.4	0.3	6.6
1978	7.8	9.3	-2.5	9.1	1.2	4.3	8.4	1.3	-2.0	-3.4	5.6
1979	12.5	14.4	7.3	12.2	4.8	13.3	15.5	2.7	6.3	3.8	11.1
1980	14.0	13.4	17.9	16.3	7.5	8.8	20.1	8.2	5.8	5.2	13.5

Source: All data are wholesale price indices from International Financial Statistics (various issues), line 63.

1/ Series based on industrial output prices.
2/ New series based on industrial product prices.
3/ Series based on industrial goods prices (tax included).
4/ Series based on home and import goods prices.
5/ New series based on final product prices.

Table 3. Dollar Liabilities of the United States Government To Foreign Central Banks and Official Agencies

(In billions of U.S. dollars; year-end stocks)

	Canada[1/] (1)	Japan[3/] (2)	Western[2/] Europe (3)	Total (1) to (3)	Annual Percentage Change (5)
1963	1.79	1.59	8.51	11.89	
1964	1.81	1.50	9.32	12.63	+6.2
1965	1.70	1.57	8.83	12.10	-4.4
1966	1.33	1.47	7.77	10.57	-14.5
1967	1.31	1.45	10.32	13.08	+23.7
1968	1.87	2.26	8.06	12.19	-7.3
1969	1.62	2.61	7.07	11.30	-7.9
1970	2.95	3.19	13.61	19.75	+74.8
1971	3.98	13.78	30.13	47.89	+142.0
1972	4.25	16.48	34.20	54.93	+14.7
1973	3.85	10.20	45.76	59.81	+8.9
1974	3.66	11.35	44.33	59.34	-0.8
1975	3.13	10.63	45.70	59.46	+0.2
1976	3.41	13.88	45.88	63.17	+6.2
1977	2.33	20.13	70.75	93.21	+47.6
1978	2.49	28.90	93.09	124.48	+33.5
1979	1.90	16.36	85.60	103.86	-19.9
1980	1.56	21.56	81.59	104.71	+0.8

Source: All data from International Financial Statistics of the International Monetary Fund.

1/ Line 4aad, IFS (United States).

2/ Line 4abd, IFS (United States).

3/ Because direct U.S. liabilities to the Japanese Government were not available, the virtually identical series on total Japanese reserves in foreign currency was used--line 1 d.d, IFS (Japan).

Table 4

Monetary Aggregates in the United States, Germany and Japan

January 1980 - July 1981

	United States - MIB 1/ (billions of dollars)	Germany M1 2/ (billions of deutsche marks)	Japan Money 3/ M1 (billions of yen)
1/80	397.2	226.9	64,894
2/80	387.5	229.5	66,061
3/80	389.1	228.7	71,058
4/80	393.9	229.7	70,511
5/80	384.7	234.9	68,021
6/80	394.3	237.1	68,131
7/80	401.8	236.2	64,818
8/80	405.4	236.0	65,963
9/80	412.3	237.8	64,392
10/80	418.4	238.7	63,114
11/80	421.9	263.6	65,915
12/80	425.9	257.3	69,573
1/81	423.5	241.0	63,794
2/81	411.5	240.6	64,685
3/81	417.8	232.4	68,023
4/81	436.7	233.3	68,849
5/81	424.4	237.7	73,026
6/81	428.4	242.5	71,245
Annual Growth: 6/80 to 6/81	8.6%	2.3%	4.6%
7/81	433.2		

1/ Not seasonally adjusted. Equals currency plus demand deposits, travelers checks, and other checkable deposits. Source: Federal Reserve.

2/ Not seasonally adjusted. Equals currency in circulation and domestic non-banks' sight deposits. Source: Deutsche Bundesbank.

3/ Not seasonally adjusted. Equals currency in circulation plus deposit money. Source: Bank of Japan.

Chairman Domenici. Senator Gorton, do you have any questions?

Senator Gorton. I tried without complete success to follow your total line of thought, but maybe a couple of simple questions will help me.

Is it your view that at the current time and in the course of the last 6 months or a year there has been a net investment in the United States in both short- and long-term securities from Europe and from our other trading partners?

Dr. McKinnon. Anytime we show a current account deficit in the balance of payments there is, just by accounting, net investment in the United States by foreigners.

Senator Gorton. So that that net investment has continued for some considerable period of time?

LARGE DEFICIT PROJECTED

Dr. McKinnon. Well, it is very cyclical. Occasionally we show a current account surplus. But with the OPEC problems typically it has been deficit; and at the time, as you see, we are projecting a large deficit.

Senator Gorton. But is it the thrust of your views that this provides an upward pressure on interest rates?

Dr. McKinnon. Downward.

Senator Gorton. OK. I would think that it would.

Dr. McKinnon. It is this current account deficit which is the counterpart of a net capital inflow into the United States. Foreigners buy U.S. bonds and equity, and in that way, they keep interest rates lower in this country than otherwise.

Senator Gorton. Exactly, because without that money coming in, the pressure of our Government's deficits would create even higher interest, would they not?

Dr. McKinnon. That is right.

Senator Gorton. Then at least in the short run from the point of view of someone looking only at interest rates this is the desirable situation.

Dr. McKinnon. Yes; to allow a current account deficit to develop naturally in response to our large projected fiscal deficit, and not to send officials to Japan or Europe to complain about their current account surpluses.

Senator Gorton. Well, would you explain to me once more: In what respect would this trend be strenghened or what respect would our economy be strenghtened by this tripartite view of the Federal Reserve Board that took into account the money supply in West Germany and Japan at the same time? What is the connection between these two? Why would that be more desirable than the situation with which we are faced now? Because under such a situation we would have a somewhat less restrictive money supply here in the United States?

Dr. McKinnon. At the very present moment it would mean the Fed should expand, nudge M_{1B} upward until the combined money supplies of the three countries were on their long-term path, defined appropriately.

Senator Gorton. That would also have a downward impact on interest rates?

Dr. **McKinnon**. That would nudge down the dollar in the foreign exchange markets and short-term interest rates would come down.

Senator **Gorton**. And what would its effect be on those two trading partners?

SWITCH TO INTERNATIONAL MONEY GROWTH RULE

Dr. **McKinnon**. Their money supplies would expand and their currencies would appreciate slightly. So the world system as a whole would expand somewhat. They are very depressed at the present time, and as you know, they complain a great deal about this depression. My point is that we have forced them into a monetary contraction, not wittingly, but just an incidental byproduct of our own policy. Switching to an international money growth rule, however, is a way of letting all three nations get out of this contraction that is occurring without appearing to jeopardize monetary control in the long run.

Senator **Gorton**. So it is your view than that all three nations would gain from this policy?

Dr. **McKinnon**. All three nations would gain, but it is more than just a view of the moment. I think the monetary policy should be conducted jointly among all three in the future. Then we would avoid such things as the massive inflations that occurred in the seventies, as well as avoiding sharp contractions such as that which is now occurring.

Senator **Gorton**. Thank you. Our next witness is Dr. Allan H. Metlzer.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF ECONOMICS, CARNEGIE-MELLON UNIVERSITY

Dr. **Meltzer**. Thank you, Senator.

I think I would like to comment on Dr. McKinnon's remarks. We have enough problems to solve in our own country and enough difficulty coordinating the branches of our Government, without trying to coordinate with other governments. Others may not see these problems as we do, and the problems will not become easier to solve when they are put into an international context.

I have submitted remarks for the record. Let me summarize my views.

SHADOW OPEN MARKET COMMITTEE

In 1973, several friends and I organized a group called the Shadow Open Market Committee. Since then, we have met every 6 months and reaffirmed our commitment to a particular set of policies, while adjusting our recommendations to the particular circumstances of the time.

Broadly speaking, we have advocated a policy of gradual, sustained, preannounced, continuous reductions in the rate of money growth, and reductions in Government spending and tax rates.

Those policies are very similar to the policies that have now been adopted. Our aim was to reduce inflation, restore price stability and productivity growth. We wanted to do those things at the lowest social cost that we could achieve.

We believe that that program is working. It has now been enacted into law. Beginning in October, some of the effects of the fiscal side of the program will begin to take hold, beginning sometime undetermined. The Federal Reserve had made a more obvious commitment in the last year. There seems to have been a gradual, sustained reduction in the rate of money growth at an uncertain rate. This policy, too, seems to be taking hold.

RATE OF INFLATION REDUCED

If in December 1980 I had told you that by September 1981, when we meet now, that the rate of inflation would be reduced by 2 to 3 percentage points from where it was at that time, without unemployment rising and, in fact, falling ever so slightly, you would have questioned either my credibility or the basis of my forecast. And, indeed, I would not have made such a forecast.

I believe that this year we have been more fortunate than we had any reason to expect and, certainly, than anyone could reasonably have forecast. We have reduced the current measured rate of inflation without experiencing the side effects or unemployment that we had every reason to believe we were going to experience and which, I believe, we will experience as we move into the months ahead.

You would have been skeptical, and I would have been skeptical of a forecast that said that we would have had as much response in the rate of inflation as we have had. In part, it is the result of good policies, in part, the result of good luck. We have decontrolled oil prices; we have enacted the tax and spending reductions; we have a better harvest than people were willing to forecast; we have slowed money growth. One result is a bigger budget deficit than anyone forecast.

Some of the current projections for the deficit and the anguished handwringing that goes on about the deficit do not, I think, pay sufficient attention to the fact that with lower inflation, people are not being pushed into higher tax brackets and, therefore, tax revenues decline.

And with the better harvest, more money is being spent for agricultural price supports, but consumers are facing lower prices for those food products in the grocery store. And with persistent reduction in the rates of money growth, the reductions in food prices are not being offset by higher prices elsewhere but are, in fact, appearing as a lower measured rate of inflation.

With lower oil prices, the windfall profit tax yields less revenue, so the deficit is higher than we had any reason to expect. That is not something we should be wringing our hands about. That is a benefit that we get. Part of the price that we pay for that benefit is that we observe for the current fiscal year, and perhaps for the next fiscal year, somewhat higher deficits than we might like, and higher than we expected.

Back in March the Shadow Open Market Committee said:

> Doubts about the size of the deficit will not be removed, even if Congress approves the entire program. The administration's forecast of the growth of nominal income for 1982 to 1986 appear to us inconsistent with their assumptions about monetary and fiscal policies and the historical performance of the American economy. The estimates of real growth are more optimistic, and the estimates of the slowing of inflation more pessimistic than we believe the administration's policies will achieve.

I read that statement to you not to say that we told you so. Economists forecasts are not so good that we can afford to pat ourselves on the back for the good ones and neglect the bad ones.

COMMITMENT TO RIGHT KIND OF POLICY

My purpose in quoting our statement of last March is to focus on what I believe is a major problem. The commitment by Congress and the administration to its current policies is a commitment to the right kind of policy. At least, we think it is the right kind of policy. It is the general thrust of policy that we wanted.

But that policy has been, and is now, accompanied by a forecast which promises far more progress in the real sector of the economy than I believe is likely. And I think that is a generally shared view. It promises less progress against inflation than I believe we can achieve.

The result of that will be that budget deficits will be larger. A sensible way of dealing with the problem is for the administration—and the Congress should urge them to do that—to come with a credibile forecast, to face up to the problems that are actually inherent on their program. We are going to get back on the long-term productivity and real growth track of 3 percent, but we are not going to experience, in my judgment, 4½ percent average rate of real growth from 1982 to 1986. We are going to have less inflation. Slower real growth and less inflation produce a bigger budget deficit. Those are the problems that we have to deal with, and the administration must produce a credible program for dealing with them.

If that program means a larger budget deficit, then the administration should say that there is going to be a larger budget deficit. People who make decisions in the marketplace will then face some reliable facts instead of the current uncertainty: The uncertainty about whether this administration, as its program begins to unfold, will do what other administrations have done. Other administrations have leaned on the Fed to print more money; this would reverse the progress we have been making against inflation.

MAKE POLICIES CREDIBLE

The most important single thing that we can do now is to make our policies credible. We have promised people that we are going to reduce inflation not once, but half a dozen times. And each time, as the anti-inflation policy begins to work, we get the secondary effects. Unemployment rises, and interest rates rise, so we abandon the policies and go back to policies which produce more inflation. We produce the next round of problems trying to solve this period's problems.

It was for precisely that reason that in 1973 we urged the policy of sustained, gradual, committed reduction to lower rates of money growth. We urged the Government not to back off at the first sign of difficulty, but to continue on in the policy so that people become convinced that inflation will remain low. As we move through what we believe will be the recession—a mild recession but, nevertheless, a recession—people must come to believe that this time there really is an intention to carry through those policies and get the benefits that we are going to pay for in that recession.

We think that we need a commitment by Congress and the administration and the Federal Reserve to the current policies. I believe that this committee should say to the Fed, "You are doing what we wanted. Inflation has fallen more than we expected. Continue to reduce the money growth rate. Make the gains against inflation permanent and not temporary."

Our future success does not depend on achieving a particular deficit on a particular date. When deciding on spending targets, we should make as our aim in deciding how much to spend as a nation, that the principal effort should go to make our use of resources more efficient, to redistiibute—because that is a great part of what we do through the social transfer programs—to redistribute in more efficient ways, to spend for military and civilian uses in more efficient ways.

CUT SPENDING FURTHER

That means to me that we should cut spending further. I believe that a further transfer from State programs and Federal programs to private capital expenditure will increase efficiency in the overall use of resources.

And we should, as I have said, continue to slow the rate of money growth, reduce regulation, continue to float the dollar.

After 15 or more years of pro-inflation, anti-growth policies, we cannot and should not expect very rapid responses. We should, instead, persist in the policies that are working, and we would do better if the administration comes through with a better forecast setting out the problems and gains that they see.

Currently, in my judgment, we have a good policy. Money growth is a little bit too fast. Given the progress that we have made against inflation, money growth should be reduced. The Shadow Committee in its most recent statement recommended that for next year, 1982, we bring the rate of growth of the monetary base, the growth of the Federal Reserve's balance sheet, to a 5-percent rate of increase from the approximate 6 to 6½ percent—we will realize probably by the end of the year—to 5 percent next year.

If we do that, we will during 1982 continue to make sustained progress against inflation at the risk of a mild recession which we now see coming.

No one can be very certain about the future at the present time. The administration's tendency to lean against the Fed shows that it is starting to do the things that every administration does when it runs into modest problems. Administrations ask for more money growth or ask for a little bit faster money growth. No one can be very certain that when the more serious problems of unemployment begin to occur, that there will not be a further leaning against the Fed, a further request for just a little bit of help with a problem. Policies of that kind will force us to repeat the experience of every previous attempt to end inflation. We will have higher, not lower, inflation.

My own view is that the dominant skepticism which exists in the markets—whether they are the markets for commodities or the markets for money and bonds or markets for other kinds of securities—is a skepticism based upon experience with failed commitments to end inflation. The result has been that every peak in the rate of inflation for the past 15 years has been higher than the previous peak. Every low point in the rate of inflation has been higher than the previous low point. The trend has been up. It is going to take a lot of effort to convince people that the trend has turned around and is now down. The only way we can do that is to continue to insist on the policies which we know will work.

PROGRAM IS WORKING

At the present time, there is consideration being given to further budget cuts. Those of us who have long advocated policies of gradual reductions in money growth and sustained reductions in the growth rate of public spending and in tax rates never made a secret of the fact that we believed that one of the reasons for producing that particular set of policies was to reduce the effective tax rates that people face. Effective tax rates are reduced principally by reducing Government spending. A second reason is that we believe that deficits set up a climate in which it is difficult to increase spending. I think the program is working far better than even those of us who favored it could possibly have expected.

Congress is not talking about increasing spending and not talking about increasing taxes, although there are some whispers and, perhaps, statements to that effect. But Congress is talking about further cuts in the budget.

I think the timetable for those further cuts has been accelerated by the pervasive skepticism in the markets. But those cuts were on the agenda. They had to be made if we are going to get back to the use or resources which the President talked about when he initiated the program and the kind of economy that we thought we could achieve if this program is carried out.

PROGRESS AGAINST INFLATION BETTER THAN EXPECTED

So we should not be disheartened. I think we have made good progress against inflation this year, better than expected. The economy has held up in the face of very high real rates of interest better than expected, better than I believe it is going to hold up in the months to come.

We can capture the gains against inflation and make them permanent if we persist in this policy. We originally believed, and we have long said it would take 2 years of sustained commitment. We are part of the way through the 2 years. There is nothing magic about 2 years. The more people believe we will persist, the more quickly people believe we will persist, and that those commitments are serious and sustained, the quicker we will get the adjustments that reduce the cost of ending inflation. The more people believe that there is hesitancy, skepticism, and doubt about the program and its survivability, the less likely they are to make commitments to lower rates of wage increase, to lower interest rates on long-term bonds, to all the things that need to be done in order to bring the benefits of the program to their full realization.

As we go into 1982, an important year for wage bargaining and settlements, it is going to make a big difference whether we come into that year with inflation running as it has in recent months—down several points from the peak so that people can see visibly that we are not on a new anti-inflationary track—or with the beginning of a new round of inflation. That can make a big difference in determining how much unemployment and how much cost we have to pay to repair the damages of the last 15 years.

But we cannot expect to succeed in 15 weeks, and, in any case, we are not even 15 weeks past the date on which Congress passed the resolution calling for reductions in spending, tax cuts, and the implementation of the fiscal program.

Senator GORTON. Thank you, Dr. Meltzer.

PREPARED STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF ECONOMICS, CARNEGIE-MELLON UNIVERSITY

Economic policies do not work instantly. Reductions in the growth of government spending that shift resources to more efficient rises do not immediately trigger equal or greater increases in private spending. Tax cuts that encourage saving and effort do not generate instant responses. Reductions of money growth do not instantly reduce inflation. All of these policies have their expected effects only if people believe the policies will remain in effect.

For many years, this Committee advocated policies similar to those that have now been adopted. We said that, if the policies were maintaned in place, sustained higher productivity growth, increased employment and lower inflation would follow within two years. We emphasized that a more rapid response could be achieved if the policies are credible and commitment to the policies is sustained through the difficult months following their adoption.

The policies we advocated are now in place. Currently, the most reliable indicators of money growth are substantially below their past peak rates of increase. The growth of government spending is slower, and tax rates are lower.

A widespread belief persists that the administration and the Federal Reserve will not sustain these policies. Projected growth rates of defense spending, social security outlays and medicare costs appear to many observers to be incompatible with the projected real growth of the economy at lower rates of inflation. The conflict between the budget and the economic forecasts has stimulated daily discussion about the prospects of a budget deficit instead of a small surplus in 1984 amid rising cries of failure.

Intense concentration on a particular value of the budget surplus or deficit for 1984 misplaces attention. We wrote in our March statement:

> "Doubts about the size of the deficit will not be removed even if Congress approves the entire program. The administration's forecast of the growth of nominal income for 1982-86 appears to us inconsistent with its assumptions about monetary and fiscal policies and the historical record of performance of the American economy. The estimates of real growth are more optimistic and estimates of the slowing of inflation more pessimistic than we believe the administration's policies will achieve."

There is a growing conflict between the policies pursued and the forecasts of their effects. The problem is that presently no one knows which course the administration will follow. They can choose to realize their budget forecasts for 1983 and 1984 by inflating the economy in line with their forecasts of nominal income growth. Or, they can continue present policies and accept the results – a larger budget deficit in fiscal 1982 and later years. The conflict heightens current uncertainty and sustains those who believe that the lower rates of inflation we now observe are a temporary pause in the long uptrend.

Three Options

The administration has three options. One is to maintain their current forecasts. These forecasts project the average growth of nominal and real GNP at 12% and 4.5% respectively for the next three years. The forecast of real growth is well above the historical average achieved by the U.S. economy and the projected nominal growth is inconsistent with continued and sustained decline in the rate of inflation. The projected rate of nominal income growth cannot be achieved with the monetary policies that the President, leading member of his administration – and we – urged the Federal Reserve to follow. The forecasts fail to recognize the considerable progress toward lower inflation that has been achieved this year.

Second, the administration can alter its forecast while reaffirming its commitment to the monetary and fiscal policies that are now in place. This choice accepts the fact that real growth is likely to be slower, and inflation lower, than previously projected. Consequently, budget deficits in future years will be higher than current administration forecasts. By choosing this option, the administration enhances the credibility of current policy and reduces uncertainty about future policy.

Third, the administration can adjust budget and regulatory policies to achieve higher real growth while reaffirming its commitment to the Federal Reserve's announced policies of sustained gradual reduction of money growth. This option, like the second, discards the administration's February and July forecasts and thereby reduces uncertainty about the administration's intentions. In addition, this option recognizes that a substantial reduction in the measured rate of inflation has been made. The reduction in inflation lowers the growth of GNP and increases the deficit. A larger deficit achieved by reducing inflation should not be scorned. On the contrary, targets for money growth should be lowered to sustain and increase progress against inflation.

We prefer option 3. We call on the administration to reaffirm announced budget and monetary policies, to make further reductions in spending and to revise its current forecast. This option is most desirable if additional reductions in spending are made to enhance efficiency not solely for the purpose of achieving a particular value for the budget surplus or deficit on a given date. We believe that more efficient use of resources, including resources devoted to defense, can be achieved by shifting resources from public to private hands.

Budget Policy

The administration has made substantial progress toward a more rational fiscal policy by reducing the growth of government spending and by reducing tax rates. The reductions were offered as first steps toward a long-term solution of neglected economic problems. Yet, within a few weeks of Congressional passage of the budget resolution, and before the program takes effect, it is frequently and incorrectly described as a failure.

The administration should not allow current, excessive emphasis on the size of the deficit, temporary changes in stock prices or forecasts of the future deficit to dominate current concerns or obscure the goals of economic policy. A balanced budget in 1984 is not a goal of policy – and should not be made a goal of policy. A balanced budget should be achieved in 1984 only, if at all, by following policies that lead to accepted goals of more employment, less inflation, higher productivity growth and greater freedom and efficiency.

Budget reductions should be made in any category of spending that permits the administration's (defense and non-defense) programs to be achieved in ways that are consistent with these long-term goals. The administration's July projections show an increase of $118 billion in defense outlays, a rise of 17% a year from 1980 to 1984. It seems likely that a more efficient use of resources can be achieved at a slower rate of increase.

The administration should make clear that a budget deficit resulting from slower inflation is preferred to a budget that is balanced by high or rising inflation. The recent experience of Japan shows that deficits do not prevent the central bank from controlling money growth and reducing inflation but reduced inflation prevents the deficit from falling as a percentage of GNP. In Japan, deficits as a fraction of GNP are about twice U.S. deficits. Nevertheless, money growth has been lowered from more than 12% in 1978 to minus 2% in 1980. Inflation has been reduced as the economy expanded.

Monetary Policy

The Federal Reserve repeats frequently, that it is committed to sustained gradual reductions of money growth, the policies we have advocated. In its recent statement, the Federal Open Market Committee (FOMC) indicated a preference for growth of M_{1B} – currency and checkable deposits – in the range of 6 to 7% from 4th quarter 1980 to 4th quarter 1981 and a further reduction to the range of 2 1/2 to 5 1/2% in the following four quarters. These targets permit M_{1B} to reach an average of $445 billion in the fourth quarter of 1981 and make $463 billion the mid-point of the range reached by 4th quarter 1982.

The FOMC's proposed rate of monetary growth for the remaining months of 1981 is faster than would be permitted by the course we have proposed – six percent growth in the monetary base, as reported by the Federal Reserve Bank of St. Louis, from 4th quarter 1980 to 4th quarter 1981. We urge the Federal Reserve to keep money growth consistent with our target this year and to lower the growth rate of the monetary base to 4 1/2% in 1982. Our targets bring the average level of the monetary base to $172 billion in 4th quarter 1981 and $181 billion in fourth quarter 1982.

Progress Against Inflation

Our proposal for 4 1/2% growth in the monetary base for 1982 recognizes that greater progress has been made toward price stability than we, or others, anticipated six months ago. The lower than anticipated rate of inflation reported for 1981 means that growth of nominal GNP is lower than anticipated because inflation is lower.

Slower inflation in 1981 is partly a result of chance events and partly a response to firmer and better policies. Decontrol of oil prices, the decision to allow the exchange rate to appreciate without intervention, favorable harvests, and many other factors helped to lower the measured rate of inflation this year. These gains must not be thrown away.

The cost of ending inflation can be reduced dramatically if the public becomes convinced that inflation has fallen and will continue to fall. Anticipation of slower inflation means that real wage demands can be achieved with smaller increases in current wages. So far this year, the rate of increase of hourly earnings has fallen from 11%, in late 1980, to 7%. Other measures of wage changes show similar, or greater, reductions in rates of increase. Simultaneous reductions in rates of change of wages, other costs and prices lower the costs we pay to reduce inflation.

The unemployment rate is now lower than at the start of the year, and a larger fraction of the population is employed. Considerable progress has been made toward lower inflation. To date, the costs of disinflation have been much lower than anyone anticipated.

We cannot costlessly end fifteen years of inflation and low productivity growth. What is needed now is a strong commitment to continue and strengthen the policies to which the administration is committed. We should not back away from policies that are working better than we anticipated.

Senator GORTON. Doctor, when you say that we have been more successful than you or we would have anticipated——

Dr. MELTZER. To date, we have been more successful.

Senator GORTON. The program to date.

Dr. MELTZER. Yes; that is right.

Senator GORTON. And that we need not only not to abandon that program but to continue on that program, I gather from your testimony you do not mean that we have completed our task in the sense that we can simply remit what we have done to substitute for an entire program.

Dr. MELTZER. That is right.

CONTINUE TO REDUCE FEDERAL EXPENDITURES

Senator GORTON. I take it that you mean that it is necessary to continue to reduce Federal Government expenditures in the course of the work on the second budget resolution and next year, as well, is that correct?

Dr. MELTZER. That is correct; that is correct.

Senator GORTON. On the other hand, I do not see anything in your testimony that indicates that we have not completed what is an appropriate task in the reduction of taxes.

Dr. MELTZER. That is right. I believe we have done very well in the tax area. We have shifted the burden of taxes away from capital and, to some extent, onto consumption. And at the same time we have tried to encourage saving. And that is a shift in taxes that will yield higher investment relative to consumption, more productivity growth in future years, and higher rates of growth of income.

Senator GORTON. You distinguished between deficits which are a result of a success in an anti-inflationary program and deficits which results from failure than an anti-inflationry program.

Dr. MELTZER. That is right.

Senator GORTON. To what extent, then, in the immediate future—that is to say, dealing with the challenge that is facing us right now in the second budget resolution—do you think it necessary to reduce expenditures in addition to the reductions already accomplished for fiscal year 1982 and also give an indication of further reductions for the two succeeding outyears?

Dr. MELTZER. As you know, some of those reductions in spending for the outyears, in particular, were preprogramed in the sense that the administration had not come through with the announcement of the specific cuts it wanted, but it said that it was going to have to come through with some additional cuts in order to meet its goals.

And, apparently, that program has been accelerated because of the hesitancy expressed by the financial markets and by the general clamor that has occurred in recent weeks in response to high interest rates.

I think there is no harm done from forcing the administration in the second budget resolution to announce the planned reductions. In deciding on further cuts, we should not ask whether we are going to achieve a specific value of the deficit on a specific date. It is not going to make a great deal of difference whether we have a $42½ billion deficit or a $51 billion deficit in 1982. That is not the critical question.

CAN PROGRAMED MONEY BE SPENT EFFICIENTLY

The critical question we should be addressing is, Can we spend, efficiently and effectively, to accomplish the purposes we have set out, more money or less. And if one thinks that, for example, in the military spending area that there are real gains to be made by shifting resources, by slowing down the rate at which military spending increases, then I think we can do a lot to increase the credibility of the economic program and to help it along.

But I think the question we should be asking is not what the deficit should be on a given date, but can the military spend efficiently the amount of money that they are now asking to spend. And if the answer to that question is probably not, then we are better off if we shift spending to some more efficient, private use.

Senator GORTON. What is the answer to that question?

Dr. MELTZER. Well, I am not a military expert, so I hesitate. But I would say I have personal reservations and some skepticism about their ability to spend that money efficiently at the rate of increase which is currently projected in the budget for 1982 and 1983.

But I say that with a certain amount of care because I am not a military expert and have not evaluated the various weapons programs and other programs which are in the budget. But I believe that is the question which needs to be addressed by the Congress, than to say, we want to hit $42½ or $51 billion, or something like that.

Congress should ask about how are we using the resources. That is the principal question.

CROWDING OUT CAUSE OF HIGH INTEREST

Senator GORTON. Do you consider your views that you have expressed here to be consistent with those of Chairman Volcker who this morning made the case for the proposition that high interest rates are due to a crowding out of private investors because of large Government deficits?

Dr. MELTZER. No; I think that high interest rates are principally due to two factors at the moment.

I preface my remark by saying that interest rates are now higher than I believed they were going to be. So you want to take that into account when judging what I tell you next.

But I believe that there are two reasons. One is pervasive skepticism about the rate of inflation and whether it is going to be reduced permanently, or whether the administration is going to lean on the Fed to expand the money supply and reaccelerate money growth just a little bit, or maybe a little bit more than a little bit.

Second, buyers have a history of having bought securities and lost money, believing that the rate of inflation was going to come down. This makes people a bit skeptical. High short-term interest rates make the reward high for being patient and skeptical and not taking risk on long-term bonds.

As short-term rates come down, the rewards for staying short and not going long will change. If the administration would come out and say to the Federal Reserve, "We not only support the rate of money growth that you have announced but we think that you should continue on that track." Instead of saying to the Fed, "Look, why do you not ease off a little bit?" they should say "Do more. That is the policy we wanted you to follow." I think that would do a great deal more to bring down long-term interest rates over the next 3 or 4 months than a policy which says, "Maybe you ought to back off a little bit now and tighten money growth when it is a little bit easier." The day when it is going to be easy to disinflate the economy is never going to come.

My reason for believing that interest rates are high is people are not certain about what the Federal Reserve will do, and they worry about how long the administration will sustain its commitment to present policies.

Senator GORTON. Thank you, Dr. Meltzer.

We will move on to you, Dr. Tobin.

And we have just received a note that sometime between 20 and 30 minutes from now our little pinball machine behind you is going to go off and we will be required to vote and end this session. So it is unfortunate that the last person also gets foreshortened, but I am afraid it may happen to you.

STATEMENT OF JAMES TOBIN, STERLING PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Dr. TOBIN. Earlier this year President Reagan proposed a "Program for Economic Recovery" with three principal components: (1) drastic cuts in Federal budget outlays for 1982 and subsequent fiscal years, compared to the proposals and projections of the Carter budget message of January 1981; (b) drastic cuts in Federal personal and corporate income taxes phased in over a 3-year period; (c) resolute adherence by the Federal Reserve System to targets for declining growth in money stocks through 1985.

The President got his way on all three. The Congress essentially adopted his budget recommendations for 1982 and his tax proposals. The Federal Reserve has followed the desired monetary policy this year and clearly announced its intention to continue to follow it. Indeed the Fed is practicing "lower limit monetarisim," using the discretion that its target brackets for M_{1B} provide to move to or below the lower limits and scaling down its future targets.

SKEPTICISM OF PACKAGE SHARED BY OTHERS

From the beginning I have shared the skepticism of may other economists that this package would achieve the macroeconomic results projected by the administration in its estimates of real economic growth, disinflation, reduction of unemployment, and acceleration of capital formation. My reasons were briefly the following:

The targeted monetary growth seemed inadequate to support the projected economic expansion even with the assumed disinflation, without interest rates so high as to choke off the expansion itself. Moreover, the inflation rate did not seem likely to subside permanently as rapidly as the administration projections advertised, especially if the optimistic predictions on real GNP and unemployment were realized but even in the more likely scenario of stagflation and intermittent recession.

Now, in the sober dawn after the euphoria of political and legislative victory, such skepticism has spread and has infected the financial markets. To the reasons mentioned above is added one more, skepticism about the budget outlook itself. Of course many observers expressed qualms on this score last spring. But it appeared then, at least to me, that if the administration's expenditure program were taken at face value, the budget over the next few years would be on average close to neutral in macroeconomic impact. By that I mean that the then proposed tax cuts would do little more than offset the budget cuts and the expansion of revenues arising from normal economic growth and inflation realistically estimated. Now, it appears, the package is more likely to add up to a somewhat expansionary fiscal policy, not a neutral one, after 1982.

POSSIBLE REASONS FOR EXPECTING LARGER DEFICITS

In reassessing the budgetary outlook through 1984, and in reacting to the reassessment, it is important to distinguish various possible reasons for expecting larger deficits than the administration originally projected. They are: (1) The path of real output will fall short and unemployment will be higher, resulting in lower revenues and higher outlays. (2) The inflation rate will be higher than projected, necessitating larger nominal dollar outlays, but also generating higher revenues from given taxes. (3) Because interest rates will be higher than anticipated, outlays to service public debt will be higher than earlier foreseen. (4) For any given economic environment, whether as originally forecast by the administration or less optimistic in any or all of the three respects just mentioned, Federal expenditures will be higher and/or tax revenues lower than previously estimated.

UNSPECIFIED BUDGET CUTS

I first take up the fourth item. The two subitems here are: (a) Higher estimates of outlays are indicated either on technical programmatic grounds or because the eventual legislation differed from original administration proposals. According to CBO, these revisions add up to $30 billion in 1984. (b) As everyone knew last spring, the budget projections beyond 1982 envisaged further massive budget economies, then and now unspecified. The realism of these projected cuts—estimated by CBO to be $50 billion in 1984—is no more dubious now than it was then, but it suddenly seems so to many observers. In any case, it is up to Congress itself to determine whether cuts of the magnitude envisaged will be made or not.

Budget deviations of these two kinds do make the budget more expansionary, thus possibly more inflationary, than the original "Program for Economic Recovery." This is not true of the other three items, which I take up in order.

LARGER DEFICITS ARE SYMPTOM OF MACROECONOMIC WEAKNESS

(1) If the outlook for real economic activity is less promising than previously thought, and less promising than the path that the Congress and administration desire, deficits will of course be larger. But this is definitely neither a reason to expect higher interest rates nor a reason to make further expenditure cuts or to raise taxes. The larger deficits are a symptom of macroeconomic weakness, which will normally be associated with smaller demands for money and credit, and thus—for given Federal Reserve monetary growth policies—with lower interest rates, not higher. Such deficits do not crowd out private investment projects. Rather they absorb saving that, in the absence of stronger private demands for finance, would simply go to waste in even higher unemployment.

It is foolish and irrational for the financial markets to react to information that the economy will be weaker than previously thought by anxiety that the consequent Federal deficits will be crowding out buoyant demands by private borrowers and issuers of equity. The deficits will be there because those buoyant demands are not. It would be foolish and perverse for the Government to react to the prospect of such deficits by cutting expenditures and/or raising taxes. Those measures—again with Fed policy given—would simply weaken the economy further. Herbert Hoover tried this tail-chasing strategy; it didn't work then, and it won't now.

LESS OPTIMISTIC INFLATION FORECAST ALTERS BUDGET OUTLOOK

(2) How a less optimistic inflation forecast alters the budget outlook is not so clear. The first approximation answer is that it reduces the deficit in real terms, though probably increasing it in nominal terms. The reason is that outlays rise in proportion to prices, while revenues—until the Federal tax system is indexed—rise more than in proportion, because of the progressive structure of rates. However, outlays may rise more than in proportion too, depending on the specific goods and services the Government is buying and on the quirks of indexing of social security benefits and other Government outlays. There's not much in this one way or the other; it is not a major factor in reassessing the real macroeconomic impact of the budget. (I reserve until the next item the indirect effect of higher inflation via interest rates.)

I do not mean, of course, that the Congress should be indifferent to the possibility that the inflation outlook is worse than you were initially told. You might wish to adopt a tighter budget posture, and to accept a more stagnant or recessionary economy over the next 2 or 3 years, on this account. I will return to this question below.

NATURE OF INTEREST ON PUBLIC DEBT

(3) The nature of interest on the public debt, and of its contribution to the size of the budget and the deficit, is widely misunderstood, and I am going to say some shocking things on the subject. Consider fiscal year 1981, for example. Interest outlays will be about $67 billion, on a debt that averaged about $950 billion. But $325 billion of the debt was held within the Federal Government itself, by Government agencies and the Federal Reserve System. After the budget outlay for net interest is offset by receipts from the Fed, the interest payments to outside holders of the debt will be $53 billion, 8.4 percent of an average outside debt of about $633 billion. Since the inflation rate was 9 percent, the interest paid did not quite maintain the real value of the debt. As we are so often told, inflation itself is one big reason why interest rates are so high. Applying inflation accounting, like what is recommended for the private sector, to the Federal Government, we would calculate as deficit the increase in the real value of the debt held by outsiders. On this basis, the fiscal year 1981 deficit was only $20 billion, instead of the conventional reported $74 billion nominal deficit, which includes borrowing requirements of $60 billion on budget and $14 billion off budget. I would reduce both the $20 billion and the $74 billion to allow for the fact that the Government does acquire assets by lending off-budget, and that at least some of the borrowers would be demanding credit in the capital markets if they were not served by the Federal Government. An additional point, which I have not included in my illustrative recalculation, is that as a debtor the Federal Government made capital gains from the rise in interest rates during the year, which lowered the market values of its outstanding long-term debts.

ANXIETIES TRIGGERED BY RECORD HIGH NOMINAL DEFICITS

What is the relevance of this recalculation? Is it just a trick of academic accounting? No, because it is relevant to the fears that high actual and prospective deficits will flood the money and capital markets, crowding out worthy private borrowers. Fears of this kind are nothing new; for example, record high nominal deficits in the mid-1970's triggered similar anxieties. Yet they were financed by debt issues without increases of interest rates. The stock of outside Federal debt did not grow relative to national product and national wealth, the stock of savings, during the decade. Savers and portfolio managers were not compelled to shift holdings from private obligations and equities into Federal securities. There is a natural market for new issues of Federal debt, as for new issues of private debt, by institutions and individuals who simply maintain the fractions of their portfolios they hold in these forms, which would otherwise decline as a result of maturities, growth, and inflation.

PANIC NOT JUSTIFIED

What will happen to the stock of public debt over the next few years given current budget and economic prospects? Not the total in dollars, but the debt placed outside the Federal Government measured relative to the national economy. Not being a forecaster or budget expert myself, I take the CBO projections as Alice Rivlin reported them last week. Making no allowance for absorption of debt by the Federal Reserve, I find that the debt will remain 22 to 23 percent of GNP, the same ratio that has obtained since 1970. The ratio was higher than that in the 1950's and 1960's, during which Federal debt—more than 100 percent of GNP after World War II—was gradually displaced, relatively speaking, by private debt. There is nothing in this prospect that justifies panic either in Wall Street or on Capitol Hill.

Should the administration's optimistic budget forecasts come to pass, then at the end of fiscal year 1984 the debt would be 2 percentage points lower, relative to the CBO projection of GNP. Should the administration fail to make the budget savings assumed both in its projections and in CBO estimates, the debt would be 2 percentage points higher. Given the many other uncertainties, I don't think anyone in Washington, New York, or New Haven knows how to translate those 2 percentage points either way into interest rates and stock prices.

TIGHTER FISCAL POLICY AND EASIER MONETARY POLICY FAVORED

Today's high interest rates are the predictable and predicted consequence of Federal Reserve monetary policy, as clearly and candidly stated by Chairman Volcker on numerous occasions before and after January 20, as endorsed, nay one might say dictated, by the administration. Supporters of the monetary policy show both ill grace and bad logic in trying to shift the blame to new discoveries about the budget outlook. I myself favor, as I have for a long time, a different policy mix, tighter fiscal policy and easier monetary policy, a mix which stimulates capital investment relative to consumption and which would be consistent with lower real interest rates. The thrust of administration, congressional, and Federal Reserve policy has been in the opposite direction. Given this thrust, relief from today's interest rates will come when these rates—extraordinary high in real terms, that is, compared to the inflation—achieve their purpose, namely another recession.

Upward revisions of projected budget interest costs reflect partly pass-through of higher inflation forecasts and partly anticipation of higher real rates, apparently based on belated realization that the Fed means what it has been saying right along. As I argued above, higher interest outlays induced by inflation do not alter a rational calculation of the Federal deficit. As for higher real rates, their primary effect is to curtail investment spending, residential and nonresidential, durable goods purchases, and inventory accumulation. This is the way restrictive monetary policy works. The income effects on the recipients of interest—more consumption, less saving—are small in comparison; indeed supply-siders are busy telling us that saving will respond positively to the incentives of higher rates. Anyway, there can be little doubt that higher real rates of interest induce bigger reductions in investment and thus in demands for funds in the capital markets than in saving and the supplies of funds. Budget deficits, to the extent they reflect such interest outlays, are not crowding out private borrowers, but are the symptoms of a monetary policy that has already crowded them out. To cut other Government expenditures or raise taxes in order to avoid such deficits, that is, to make room for the higher interest payments that reflect restrictive monetary policy, is kicking the economy when it is already down.

Should the Congress tighten fiscal policy for 1982, and for subsequent years—without any promise that the Federal Reserve with the administration's blessing will reciprocate by easing monetary policy? I would answer this question in the negative, for several reasons. At present the economy, with unemployment above 7 percent and excess capacity around 20 percent, scarcely displays symptoms of excessive demand stimulus. Nor do forecasts for the next 2 or 3 years, even with realistic reassessments of the budget, indicate overheating. Therefore, I would suggest tightening of fiscal policy only if offset, in its effects on aggregate demand, by relaxation of monetary policies. As I stated already, this would be a desirable change in policy mix. Unfortunately, the Federal Reserve, having locked itself in by staking its credibility on particular numerical targets for M_{1B}, would not find it easy to offer such accommodation.

CHANGE IN POLICY MIX IS DESIRABLE

A change in the policy mix is desirable for international as well as domestic reasons. The United States has been appreciating its currency by its tight monetary policy and high interest rates. Making foreign goods cheaper in dollars is a factor in our temporary improvements of inflation statistics, but by handicapping American producers of internationally traded goods it is also a factor in the stagnation of our economy. At the same time U.S. interest rates put pressures on foreign central banks to raise their interest rates. In this way, monetary policy throughout the world becomes an obstacle to growth and prosperity. Our friends abroad have good reason to complain of our single-minded monetarist attack on inflation, pursued with uncharacteristic disdain toward the interests of other countries and the health of the world economy.

The argument for an austere macroeconomic strategy, for tighter fiscal policy combined with the current monetary stance, is the argument for a Thatcher-like attack on inflation, via recession, stagnation, and high unemployment for several years. There is something to be said for a strategy of painful disinflation, clearly announced and resolutely executed. It has never been the avowed strategy of the Congress or of this administration, which on the contrary has promised the country disinflation without pain. I would not recommend adoption of the Thatcher-like strategy unless it were accompanied by incomes policies designed to speed the disinflation of wages and costs and to limit damage during the transition to low inflation.

EXPENDITURE CUTTING NOT ONLY WAY TO OBTAIN TIGHTER FISCAL POLICY

If a tighter fiscal policy seems necessary or desirable, expenditure cutting is not the only way to obtain it. As embarrassing as it may be to reverse or delay some of the recent tax cuts, these options should be weighed in the balance of national priorities against the merits of expenditures programs—civilian, defense, and *tax expenditures*. Having assured the country and the Congress that $150 billion of fiscal year 1984 revenues and $200 billion of fiscal year 1985 revenues could be given away while balancing the budget in 1984 and ever after, the administration now don their fiscal responsibility hats and insist that the Congress come up with budget savings to make their forecasts come true. That is neither necessary nor sufficient for the health of the American economy, and this would not be the first administration to fail to make good on a lightly given political promise to balance the budget at the end of its term. It may be the first administration to exploit in tandem the political attractions of tax-cutting and budget-balancing in pursuit of its more basic objective, drastic curtailment of civilian programs by Federal, State, and local governments.

PROGRAM NOT RESULT OF DR. TOBIN'S ADVICE

Senator GORTON. Dr. Tobin, if I may since the buzzer has not gone off, you have mixed in with a criticism of some present policies a number of bits of policy advice, but if I can try to get them concentrated by asking you to assume that you were today back on the President's Council of Economic Advisers, what advice would you give to the President? What would you ask him to send as an economic message to Congress and to this committee in connection with its immediate future policy judgment?

Dr. TOBIN. That is a very difficult question to answer because we do not have a tabula rasa to start over again. I would not have given the advice which resulted in the program and the dilemma that we face now in the first place.

Senator GORTON. But we are here now.

Dr. TOBIN. We are here now, so it would be completely unrealistic to say, "Well, forget all of that and start over again." But one thing I did say in the statement is that I think that the President, the Congress, and the Federal Reserve jointly should move to a mixture of fiscal and monetary policies which is tighter on the budget than the outlook now is and which is easier as far as monetary policy is concerned and will produce lower real interest rates.

I recognize that we have all these credibility problems and expectations problems, and so this would have to be done in a way that was convincing to the country that it did not mean that the Federal Reserve and administration were abandoning their anti-inflation objectives or policies.

But I think that could probably be done even now, even now.

DON'T RUSH INTO BUDGET CUTS

Like Allan Meltzer, I would not rush into budget cuts which are motivated simply by either the accounting numbers of the 1982 budget or by the promise of a balanced budget in 1984—budget cutting just for the show of it. Nor would I do it in order to relieve pressures on the financial markets and capital markets in future years.

I have tried to say I think those pressures are exaggerated. I would rather reduce them, but I think they are exaggerated by the financial community.

What Congress should do, this year and every year, is to examine Federal programs and Federal transfers to State and local governments as well as to individuals on their merits, judging them in terms of national priorities as against the value to the country of the private spending that comes from tax reductions or avoiding tax increases.

Now, I think I would probably come out a little different from Professor Meltzer in assessing those priorities right now, but I imagine there are many programs that we might agree on.

I personally am not convinced of the need for more defense spending, but as an economist I do find it quite upsetting to be told:

> Well, we have got to reduce the defense budget so much and so much because otherwise interest rates will be so high in 1984 that they are already high now in anticipation, and the financial community is all upset.

I am not sure that we need 7 percent real increases in defense budget over the next few years. I am not expert on that, but I am rather inclined to doubt it. I am rather inclined to doubt also that it will be efficiently expanded at that rate.

Nevertheless, I think that it ought to be decided on those considerations, and not changed in a panic over the reaction of financial markets to the budget program.

Senator GORTON. Thank you. I had hoped to have time to let each of you comment on the testimony of the others. Since we now have a roll call I am not going to be able to do that completely.

But Dr. McKinnon, you had to go first with no chance to answer. I will give you a couple of minutes. I understand you would like to comment.

Dr. MCKINNON. Thank you, Mr. Chairman. I thought I would try to give a score card for the three of us on which ways we would want to go on monetary and fiscal policy, and what the differences are in connection with the question of why are interest rates so high.

HANGOVER OF INFLATIONARY EXPECTATIONS

I think all three would agree that there is a hangover of inflationary expectations from the past. That is one important component in high interest rates.

But we disagree, apparently, on whether or not there is a true fiscal squeeze, whether there is crowding potential or actual crowding out of private investment expenditures on the basis of projected Government budget deficits.

As I understand the testimony of both Professors Tobin and Meltzer, they are in agreement: there need not be concern for the projected deficits on the order of $70 or $80 billion for severe crowding out or for contributing much to the high interest rates that we now observe.

In contrast, I take the view that there is a potential fiscal squeeze going on, and I base much of my argument on the changed international conditions that imply our own past history is much of a guide to the future. Because other industrial countries are now running much bigger fiscal deficits than before, the U.S. Government cannot so easily tap the international capital market. The degree of crowding out will be higher than previously for a given size of the American fiscal deficit. Therefore, it would be very advantageous for the economy for the U.S. authorities to proceed with expenditure cuts or some increase in taxes if one cannot get agreement on expenditure cuts.

When we come to monetary policy, Professor Tobin and I agree completely that there is an undue short-term liquidity squeeze. We both think that M_{1B} should be increased more rapidly in the next year or so. Professor Meltzer, on the other hand, believes that we are more or less correctly tracking what should be our long-run monetary policy on the basis of purely national American monetary aggregates.

Where Tobin and I disagree, however, is over whether we should retain the idea of the monetary standard, a monetarist rule. I believe that we should not appear to throw away the long-run commitment to price stability and the monetarist rule that goes with it. We cannot have just an ad hoc increase in the money supply at the discretion of the Fed at the present time without losing credibility about the future.

The problem is to maintain a credible monetary standard so the Fed can get itself out of the dilemma imposed on it by its own [inappropprate] national rule. This is why I want to look at the money supplies of our close trading partners and reformulate the rule in terms of the joint money supply for the group. At the present time, this would point strongly to monetary expansion in the United States, but that would be strictly temporary until the money supply for the group was tracking correctly. Because this reformulation would be done in conjunction with a stable exchange rate policy within the group, it amounts to a kind of gold standard policy without gold—and without any of the disadvantages of an actual gold standard.

Senator GORTON. Thank you. I would like to thank all three of you. I hope that if either of the other two disagree violently with Dr. McKinnon's views, I would hope you would do so in writing.

Thank you for helping our continuing education endeavor and at least providing us with additional information on which to make very, very difficult decisions for the immediate future.

You have been most helpful, and I appreciate your being here today. The meeting is adjourned.

[Whereupon, the committee adjourned at 4:10 p.m., to reconvene at the call of the chair.]

EFFECT OF THE PRESIDENT'S ECONOMIC PROGRAM ON THE FINANCIAL MARKETS

MONDAY, SEPTEMBER 28, 1981

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 10:11 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Kasten, Chiles, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The committee will please come to order. We are going to get started. There will be additional Senators arriving. Normally, if we wait any longer, a number of them will not get an opportunity to ask questions. I have an opening statement that I would like to read and then we will move right into your testimony. I am aware that you might not all have prepared statements for today because of the short notice, but I am sure that there will be a number of questions.

I want to welcome you all here this morning. First we have Mr. David Williams, who is chairman of the board of Alliance Capital Management Corp. and is the former chairman of Mitchell Hutchins, Inc., a major Wall Street investment firm. Then we have Mr. Walter Stern, vice chairman of Capital Research Co., and director of Capital Group Inc. Mr. Stern was formerly senior executive vice president and chief investment officer of Drexel Burnham, Inc. Both Mr. Williams and Mr. Stern are past presidents of the New York Society of Security Analysts. Finally, we have Mr. Joel Leff, who is managing partner of the investment firm of Forstmann-Leff Associates, which I understand is one of the most rapidly growing investment firms on Wall Street. Mr. Leff was a former economics professor at Harvard. Together, I understand that you manage about $25 billion in financial assets.

DOUBT STILL EXISTS IN MANAGING AND CONTROLLING DEBT

I am told that today is an exceptionally difficult day in both England and Japan, and I am sure you are wondering what is going to happen here while you are here testifying. I have a great deal of difficulty understanding the whys of all this. I think we must hear from people like you and others so that you can help us understand why. My conclusion is that, in spite of monumental spending reduction legislation and a monumental tax cut, there is still significant doubt as to whether we are going to be able to better manage and control our debt, not only in 1982 but over a period of time.

I do not think I have to recite to you three the recent history of the Federal budget. Spending has far outstripped Federal revenues. Even in fiscal 1979 when, by rights, the budget should have been near balance, we had a $27 billion deficit. Next year, even if we were to hold our deficit for 1982 to the President's level, the Federal debt outstanding will exceed $1 trillion. By spending in excess of our revenues so consistently in the past, we have a rather large mortgage on our future productive growth by reducing the value of all financial assets, and we have tried to pay for our excesses with inflated dollars.

Having spent 8 years here in the Senate, and having watched spending from the point of view of a city mayor before that, I can assure you all that there is a greater chance today than in the last 30 years, in my opinion, to control Federal spending because of the resolve of this administration. And I do not sell short at all the rather significant public support for fiscal restraint, and I do not think you all should either. I have a great deal of confidence in this budgetary process, which you know is rather new to the institutions here on the Hill.

NEED TO ESTABLISH CONTROL

I think it is true that control means much more than reduced deficits. In fact, we could establish the firmest control possible and still run deficits. Control, the kind of control that will reassure Wall Street and reassure me and, I am sure, many, many Americans, would best be reflected in reducing the growth rate of the Federal Government. Under the plan approved by this committee and under the President's plan that is unfolding, we would establish that kind of control. I would ask all three of you today for your judgment. If we could establish control, if the future growth rate were indeed half of what it has been in the past 4 years, then would inflation decline, would interest rates drop, and all of those things that seem to be necessary from the standpoint of what we hear of Wall Street's concerns?

CONTROL OVER ENTITLEMENT PROGRAMS

I also would like to address the issue that I think is the most glaring missing link, and that is control over the so-called entitlement programs. Entitlement is a promise to pay a recipient a certain sum if that recipient meets criteria. As such, Congress can exercise little year-to-year control over the amount of payment, the number of recipients, or the total cost to the taxpayer of the program. Part of that problem is that those programs, for the most part, are indexed. Part of the problem is that we have unwisely defined recipient groups, but a good part of the problem has been unwillingness on the part of those here and in the White House to grapple with the issue of indexation and defining the appropriate recipient groups.

There is surely no doubt in anyone's mind that the American people, the President, and this Congress recognize the problem. I simply do not agree with those who label the high interest rates "Wall Street myopia and herd instinct." There is a clear problem in our ability to control Federal spending. The jitters are well founded, and I think we in Congress have to address the heart of the problem. I for one would not be nearly so concerned if Wall Street was only the one-quarter-mile stretch in mid-Manhattan, but it is not. It is, in truth, an interstate highway that rambles through every State and every pocketbook in this country, at least as far as I am concerned.

BUDGET LIKELY TO PRODUCE LARGER DEFICITS

I conclude that the lingering case of nerves seems to stem from the news that the Federal budget seems likely to produce deficits larger than are economically healthy and politically acceptable.

You are ever watchful. You knew months ago what the facts were. All of us in policy positions knew months ago the enormous problems that we face. In short, the present projected deficits are no shock and no surprise, at least not to me. And, of course, more pessimistic economic projections of conditions nearly 30 months away would yield even larger deficits.

I think we can do more and we must. The President has presented us with the broad outline of his goals.

I believe Congress will begin to look at ways of curtailing the growth of the entitlement programs so that the restraint will be long lived. Then perhaps the nervous people in this country can rest easy and the economy can resume noninflationary growth, which is so fundamental.

I appreciate your patience in listening to my observations. That is not why we are here. We are to hear yours. I understand that, because we did not give you enough time, you have only brief prepared remarks. We will make those a part of the record, but we will let you handle it as you see fit.

Senator, did you have any opening remarks?

OPENING STATEMENT OF SENATOR GRASSLEY

Senator **Grassley**. Mr. Chairman, I do not really have any opening statement, but I do want to make these comments. I look forward to establishing a continuing dialog between the financial community and the Congress. I am looking for whatever we can do here in Washington to assure the financial community and the people of this Nation that we are serious about changing the patterns of spending we have pursued for the last 25 years. It is time for Government, like individuals and businesses, to live within its income. It is going to take a long time to get to that point. There are many political hurdles to overcome, many patterns of living that must be changed; not only for individuals but, more importantly, for Government as well.

We are serious about making these changes. We had hoped that some of the very dramatic changes we had made in the appropriations process and in the tax bill that has passed Congress would be evidence that we are serious about making these changes. We are serious about pursuing those policies that will indicate to the public at large that this is no longer a business-as-usual Congress or a business-as-usual administration.

At this point we feel some frustration because the radical changes we have made should have signaled that we are serious about the changes we are making. This does not seem to be the case. That frustration, I suppose, is a bit premature, since the economic program will not start until the beginning of fiscal year 1982.

You will probably be responding to this in your statements, but I would like to question you gentlemen as to whether we have done enough at this point.

Chairman Domenici. Thank you very much, Senator Grassley. Mr. Leff, could we proceed with you first? Would that be satisfactory?

Mr. Leff. I thought I was the last.

Chairman Domenici. All right, we will put you last. We will reverse the list here. Mr. Williams, do you want to proceed?

STATEMENT OF DAVE H. WILLIAMS, CHAIRMAN, ALLIANCE CAPITAL MANAGEMENT CORP.

Mr. Williams. Thank you very much, Mr. Chairman.

My name is Dave Williams. I have been a professional investor for 20 years. I am chairman and chief executive officer of Alliance Capital Management Corp. Alliance Capital is one of the Nation's largest managers of corporate and public employee pension funds. We manage about $10 billion of such funds in stocks and bonds. In 1981, our stock transactions have accounted for about 1 percent of New York Exchange volume.

WALL STREET APPROVES OF REAGAN'S ECONOMIC POLICIES

Every day for the last several weeks I have read national press articles about Wall Street's opinion of President Reagan's economic program. For example, the New York Times has regularly declared that Wall Street disapproves of or has lost faith in the administration's policies.

These articles are very puzzling to me. Every morning I go to work on Wall Street and spend all day working with and talking with other Wall Streeters, and we are all surprised and dismayed by what we read in the papers. We do not agree with the opinion expressed in these articles, and we think we are Wall Street.

Suppose that every morning you read in your newspaper: "The Senate believes the national debt should be larger. The Senate thinks inflation is unimportant." You would know that you did not agree and that your fellow Senators did not agree. Imagine how puzzling and frustrating you would find those articles.

Well, Wall Street is less clearly defined and probably less homogenous than the U.S. Senate. But, even so, I think I am safe in saying that Wall Street is highly approving of President Reagan's economic policies.

INVESTMENT STRATEGISTS HAVE ADVICE ON ECONOMIC POLICIES

In an effort to bring you what Wall Street really thinks about the Reagan economic policies, I conducted interviews late last week with eight highly regarded investment strategists from leading research-oriented stock and bond brokerage firms such as Merrill Lynch, Morgan Stanley, Goldman Sachs, et cetera. These strategists are the people who advise firms like mine on the outlook for the capital markets.

First, all eight reject the notion that Wall Street disapproves of the President's policies. I quote one: "Wall Street is nearly unanimous in its approval of Reagan's policies." All eight expressed satisfaction with the administration's actions to date, with comments ranging from good to great to beyond my wildest expectations. What advice do these investment strategists have for our Government on its economic policies? All eight were unanimous on these points: Keep cutting the Federal Government budget, with particular emphasis on 1983 and later years. Encourage the Federal Reserve to maintain money growth on a low inflation path. And, three, be patient.

One of my strategists summed up his views as follows:

> Reagan is cutting taxes, reducing the size and scope of government, freeing markets, encouraging savings, and controlling money. Nothing less will break a 20-year habit of rising inflation and slowing productivity.

Advice from another:

> Don't expect the stock market to greet all this with unalloyed joy. Getting off the inflation binge has got to be painful for some. Short term, we are going to see lower corporate profits and some big bankruptcies. These are inevitable side effects. But 8-percent or 9-percent unemployment next year will prevent 20-percent unemployment in 5 years.

BUDGET-CUTTING

First then, budget cutting: today's intense focus on the size of the fiscal year 1982 deficit is an overrated issue. The administration have painted themselves into a corner with a precise, sacred estimate, and the press is pillorying Reagan by invoking the Wall-Street-disapproves line. What is most important to long-term economic health is the size of Government spending relative to overall economic activity. Thus, the continued urging by investors for further budget cuts, not just in 1982 but, most importantly, in later years.

At last, we have reached the goal that cynics have always said was necessary to control Government spending: taxes appear to have been cut to the point of dangerously enlarging the deficit. The bond market is in disarray. Only under these pressures will democratic government rein in spending. The cynics may be proved right.

I and many of my colleagues believe there are two major budget areas that can be significantly reduced below the administration's present projections: Social security and defense.

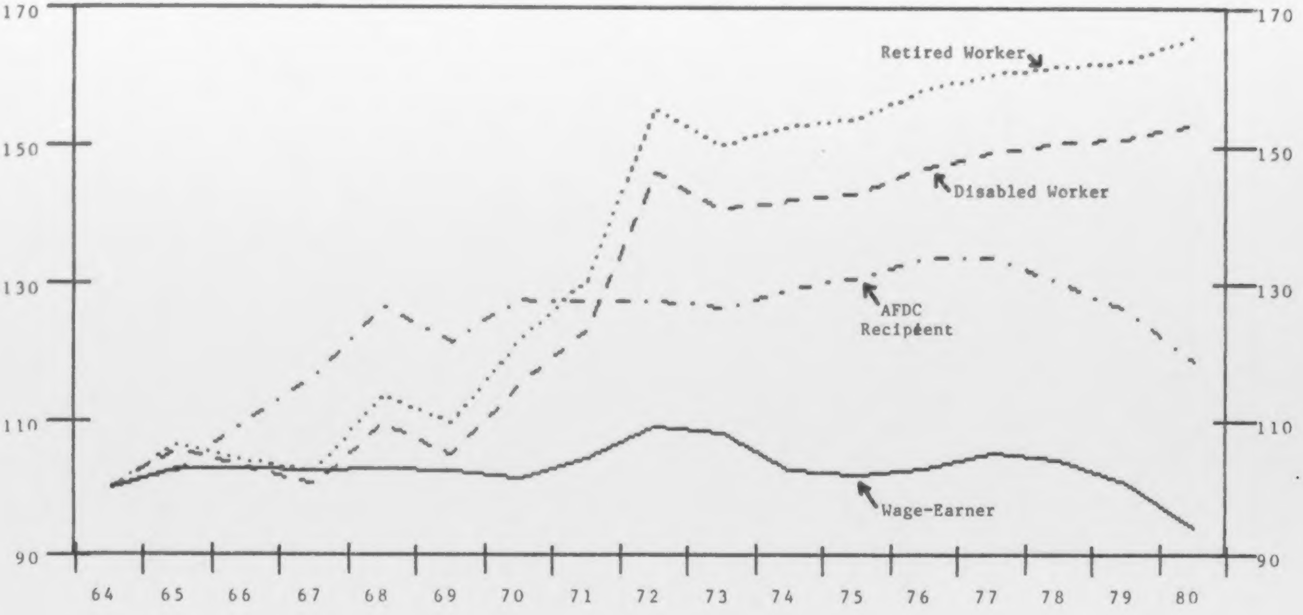
SOCIAL SECURITY

The National Bureau of Economic Research has pointed out that between 1970 and 1980 social security old-age and survivor benefits per recipient rose 55 percent in real dollars. During this same time period, average constant dollar gross weekly earnings of private nonagricultural workers rose only 2 percent. To repeat: plus 55 percent for retirees, plus 2 percent for the average worker.

Please refer to figure 1. This shows the same story with slightly different data over a longer timespan. As noted, the spread has grown even wider, about 70 percent, between the average worker and the social security retiree, when 1964 is used as a base year.

Figure 1

AFTER-TAX REAL INCOME OF A WAGE-EARNER
COMPARED TO AVERAGE REAL MONTHLY BENEFITS OF A
RETIRED OR DISABLED WORKER OR AFDC RECIPIENT
(Index, 1964 = 100)



Sources: U.S. Social Security Administration; U.S. Department of Labor; DLJ.

In other words, over the past 10 to 15 years, a very substantial amount of wealth and income has been transferred from the productive to the nonproductive segment of our economy. If productivity growth is to be restored, this must stop, and the balance be redressed. I recognize that retirees are viewed as a potent political force. But the political and financial problem will worsen as the inevitability of demographics raises the ratio of retirees to workers. So now is the time to act, while there is still a large majority of workers.

The capital markets would respond positively to credible efforts to contain this problem, as would the majority of voters, who are working, not retired.

Chairman DOMENICI. Why do you limit your discussion to social security retirees?

Mr. WILLIAMS. As I say in here later, I think that there are a lot of other areas that are very appropriate for reduction in rate of increase in Federal spending. I focused on social security retirees because the data was available; it was easy to make the case. I think that similar case could be made in a lot of the other entitlement programs to which you referred. It is just that social security data in 3 days was easy to put together.

Chairman DOMENICI. Thank you.

DEFENSE SPENDING

Mr. WILLIAMS. Defense spending is a second area that may be available for substantial reductions from present plans, particularly post-1982.

That some substantial increase in spending is required is beyond doubt. The low level of military pay and its effect on the quality of military personnel is especially alarming.

But are present plans for strategic spending sensible? My firm, like others, employs analysts and consultants on weapons systems, advanced technology, and international politics to help us grapple with investment topics affected by these issues. My comments about defense spending are, therefore, based on considerable research and analysis.

B-1 BOMBER AND MX MISSILE

The United Sstates is about to launch two new major, incredibly expensive, strategic weapons systems: the B-1 and the MX. Both seem flawed in concept. Is the B-1 worth the price when compared to B-52's with cruise missiles? How close is any manned strategic bomber to obsolescence? Are not odds reasonably good that a Stealth bomber could be deployed in less than 5 years after the B-1 is active? Are not cruise missiles and the Trident our best strategic systems for the eighties, to tide us over until new technology can be utilized in the nineties.

The same argument applies to the MX. First, the shell game land basing system is an affront to commonsense. Will not the Russians build the capability to destroy all of the silos, the empty ones as well as the full ones? Could not resources be better used to develop an effective antiballistic missile? Again, depend on the cruise missile and the Trident to see us through today's window of strategic vulnerability.

Thinking more broadly, is our emphasis on the strategy of assured mutual destruction really appropriate? As communications improve, will the world populace tolerate such thinking? Assured mutual destruction would certainly not be a popular idea if it were understood. And over the next 10 years it may become better understood. Are the B-1 and the MX the last hurrah of an obsolete theory?

MORE SPENDING NEEDED FOR ENLARGED NAVY AND RAPID DEPLOYMENT FORCES

It is said that generals always fight the last war, and assured mutual destruction may be an example of this. So, too, may be the preoccupation with a tank war in Europe and protection of the Atlantic seaways. I suspect our needs are greater for protection of the oil export seaways which serve not just the United States but Europe and Japan, too, and our ability to deploy conventional forces in meaningful terms quickly. More spending is badly needed for an improved and enlarged Navy and rapid deployment forces.

My plea to you is that the U.S. Congress undertake an intensive review of our defense strategy and resource allocation. A more coherent and logical defense strategy and a smaller projected defense budget would be very beneficial to the stock and bond markets.

Opportunities for budget and expense cutting exist outside of social security and defense, and there are more opportunities in defense than I have enumerated. Time limits prohibit my mentioning these. I would welcome questions about them later.

SLOW GROWTH OF MONETARY AGGREGATES

The Congress can also play a needed role by publicly supporting the Federal Reserve's efforts to slow the growth of monetary aggregates to noninflationary rates. Substantial progress has been made in this regard over the past 10 or so months, albeit at the inevitable price of high short-term interest rates.

Monetarism is often criticized on the grounds that there is no accurate definition of money. The press and short-term bond traders make much of the weekly M figures, detracting from the credibility of monetarism. But the historical evidence is overwhelming. Long-term, 2 years and longer, trends in money growth, however money is defined, correlate with inflation. We are nearly a year into a successful slowdown of money growth. Let us not waste that effort.

My final topic is the importance of patience in economic and capital markets matters. Please recall that "be patient" was part of the advice from my poll of investment strategists.

INTEREST RATES

First are interest rates. The marvel is not that rates are so high but that they stayed so low for so long. In a high-tax-rate, high-inflation economy, only the least sophisticated failed to borrow at negative aftertax costs of money in yesterday's era of low interest rates.

But things have changed. Accept that the Federal Reserve is the primary determiner of short-term interest rates. Before the elimination of regulation Q, the Fed could slow money growth and create a recession by choking off the availability of money. Lending institutions stopped making loans when depositors started withdrawing funds that regulation Q mandated be paid returns far below market levels.

As always happens, people learned how to evade market regulation. So there is no more regulation Q. And, without regulation Q, banks can pay market rates for most deposits and keep lending. So price, the interest rate, is now the rationer of credit. The Fed cannot regulate availability, unless they put on controls, as was done briefly in early 1980. So short rates now reflect supply and demand conditions. And, if we are to ever break the higher and higher inflation syndrome, this is the way it must be. So please be patient. If we are not patient, and politics forces the Fed to stop controlling money and to lower interest rates, the capital markets will react adversely. We would see really high long-term interest rates, perhaps as high as 20 percent, under those circumstances. Credit or capital allocation controls would have the same adverse effect.

Long-term interest rates are a somewhat different story. Here, investors' inflation expectations are said to dominate. But I am not sure that is true. My own experience is that the bond market is very slow to react to changed circumstances. Or, said another way, expectations are based on the most recent experience, not a view of the future. For example, long-term—bond—interest rates stayed extraordinarily low in 1978 and 1979, as the economy spiraled toward runaway inflation. Long-term money was a real bargain for borrowers in those years.

INFLATION OUTLOOK

Today the opposite is true. There has been great progress in controlling inflation. Most commodity prices are falling. The Consumer Price Index, if one adjusts for its inadequacies around housing costs, is slowing. Markets such as energy and transportation are being freed of controls; and, as we all surely know by now, price controls and market regulation stimulate inflation. A sincere effort is being made to control the size of Federal Government and the Federal deficit. The dollar is strong; money growth has slowed; world energy conservation has exceeded expectations, thereby lessening the power of OPEC; U.S. crops are abundant.

In short, the inflation outlook is very encouraging, more so than in a long, long time. So why is not the bond market higher and long interest rates lower? I attribute it to that old habit of the bond market, of never believing that tomorrow will be different from yesterday. So patience is again required here. In time, if today's policies continue to be applied, long-term interest rates will fall.

PATIENCE AND STICKING WITH THE PROGRAM

Continue to reduce Federal Government expenditures and, most important, plans for future expenditures, and supporting Federal Reserve efforts to control the growth of money.

Patience is also needed as we await the effects of supply-side tax cuts. Because of bracket creep and the January 1, 1982, social security tax increase, the supply-side experiment will not truly begin until summer 1982. With the opposition already calling it a failure, it is not easy to be patient, but it is imperative.

In conclusion, I would like to ask this group to open better lines of communication with Wall Street. We capital market practitioners are better able to explain the message of the markets than is the press. Please call on us again. Thank you very much.

Chairman DOMENICI. Thank you very much, Mr. Williams. Unless there is objection, we will hear now from Walter Stern.

STATEMENT OF WALTER P. STERN, VICE CHAIRMAN, CAPITAL RESEARCH CO., NEW YORK, N.Y.

Mr. STERN. Thank you. My name is Walter Stern. I am vice chairman of Capital Research Co., an affiliated company of the Capital Group, Inc., of Los Angeles. We manage both pensions and endowments and a series of mutal funds including a cash fund. The group together manages in excess of $12 billion.

I might say that we have been cautious on both the equity markets and the long-term bond market, although we do not have any single point of view within the company. I therefore speak for myself rather than for the company as a whole.

I appreciate the opportunity to share some views with you. I want to address very quickly some of the questions that you raised in the letter of invitation.

INTEREST RATES

First, I think interest rates have stayed high in recent months for the clear reason of the interrelationship between present supply and anticipated demand for funds and present and anticipated rate of inflation. Without any doubt, the fear of large deficits in 1982 and 1983 have contributed to this.

PRESIDENT'S ECONOMIC PROGRAM

Second, I think the President's economic program has had a very mixed impact on interest rates. I would say the general perception is that it is very favorable long term but has been met with considerable suspicion short term. At the moment, many investors feel there is uncertainty as to whether the budget deficit may not be both inflationary and cause crowding out of private borrowing, therefore sending interest rates even higher over the next several months. The paper this morning is full of several such predictions. Conversely, further budget cuts might accelerate recession, causing a further shortfall on the revenue side and thereby, further increasing the deficit.

RESPONSE OF FINANCIAL MARKETS

The probable response of financial markets to congressional efforts to cut Federal spending is, in my view, very difficult to predict. If these cuts were sure to be enacted, I would guess their short-term impact would be favorable. If, however, there is some question as to whether or not they will be enacted, as appears to be the case right now, these proposed cuts may increase uncertainty and have a short-term negative impact.

At the present time, the very high level of short-term rates, from an investment point of view, makes the decision to stay short in fixed income and hold reserves in equity areas a very easy and painless decision. This is compounded by the fact that most traditional bond buyers have had a disastrous experience with bonds for several decades and, more importantly, have lost very substantial amounts whenever they have made forays into the bond market in the last 3 years and the last year. In fact, some of these purchases were clearly generated by long-term enthusiasm for the Reagan program, but any efforts to capitalize on this by making money in the bond market has been met by losses. As a result, bond buyers are quite gun shy. Without any doubt, investors tend to react to their recent experiences, and at the present they have nothing but losses to show for buying bonds over the last year, 2 years, 3 years, or 10 years.

It will undoubtedly take time for traditional bond buyers to regain confidence. I would say—on the positive side—in the last few weeks there have been some signs that this process is beginning to get under way. In my view, further budget cuts could very well accelerate this process, although the question that Senator Grassley raised; "how much is enough?" is a question that I cannot answer.

CREDIBILITY AND SIZE OF DEFICIT IN FUTURE YEARS

More important than the actual number for the budget deficit in fiscal 1982 is the credibility and size of the deficit in future years. Right now, estimates in Wall Street range anywhere from zero up to $80 or $100 billion. Anything that increases confidence in the probability that this figure will be heading down rather than up would surely be helpful in creating a more positive psychology.

Senator Domenici asked: "Is it Wall Street myopia and herd instinct that is causing the current distress in bond markets?" Other Senators have asked or suggested that it is a small cabal of decisionmakers on Wall Street that make interest rates. I wish it were so.

Some people think it is Joe Granville. That reminds me a bit of the story of the steeple in the Vermont town that has been standing there for 200 years and is getting rotten. Every time the wind blows, somebody predicts it is going to fall down. Finally, a sparrow alights on it, and it falls down, and he is blamed for the downfall. I feel the same way about blaming any particular economist or even Joe Granville.

ECONOMIC ASSUMPTIONS OF REAGAN ADMINISTRATION IN DOUBT

You might ask why has not the Reagan program lowered inflation expectations and why has not Wall Street reacted favorably? I believe that the economic assumptions of the Reagan administration are very much in doubt. There is an implicit assumption that the program will cause a surge of economic activity and lower interest rates, and that these, together, would generate enough revenues to close the deficit. So far, these assumptions are just not believable and do not stand the test of rigorous analysis. But I would also point out, as Dave Williams has, also done that—since they are just starting—there really has not been enough chance to see how they work and no one has given them a chance yet to work.

Short-term influences are still predominating. Every day there is a barrage of pessimistic forecasts out. Today's New York Times and Wall Street Journal are a good example, suggesting that the bond market is going to go lower, that buyers are withdrawing from the market.

Without any doubt, budget cuts will help, although, if those cuts that have been announced are not passed, I would point out again it will have an adverse effect on the market.

Financial markets are in a state of disarray. These perceptions are, however, subject to change. Further budget cuts, in my view, could be a great catalyst in bringing about these changed perceptions.

I would like to stop there and hope that you may have some questions later on.

Chairman DOMENICI. Thank you very much. Senator Chiles, did you have any opening remarks before we conclude? Or would you rather wait until the witnesses are through?

Senator CHILES. I have no statement at this time.

Chairman DOMENICI. Mr. Leff, we are delighted to have you with us.

STATEMENT OF JOEL B. LEFF, MANAGING PARTNER, FORSTMANN-LEFF ASSOCIATES

Mr. LEFF. My name is Joel Leff, managing partner of Forstmann-Leff Associates.

Unlike my two associates, we are a smaller firm. We manage $2.5 billion of mainly pension fund assets. I would like to try to address my comments to today, in a more general philosophical tone, to the injurious nature of inflation upon capital assets.

ADMINISTRATION'S POLICIES ARE APPROPRIATE ANTIDOTES TO STAGFLATION

The administration's fiscal and monetary policies are, in the opinion of our firm, conceptually appropriate antidotes to the country's present stagflation. Although they are causing and will cause a great deal of equilibrium, years of financial mismanagement cannot be eradicated in a day.

Since the Vietnam war, decisionmakers have repeatedly erred in selecting prudent fiscal monetary solutions to the problems at hand. The obvious consequence has been a public sector growing at so gargantuan a rate that its encroachment upon private enterprise has unleashed an intolerable inflationary spiral.

It is unfortunate that the well-intentioned administration which is so courageously addressing the cumulative blunders of the past has instituted policies which, although philosophically faultless, are in practice so flawed they could lead to further financial chaos. A fallacy in the Government's equation is an overestimation of the revenue side of the budget in light of recently instituted tax cuts. It is essential that tax policy be reconsidered as well as further budget cuts and better synchronized with the dollar savings from the streamlining of Government expenditure. If such policies are undertaken, the fiscal imbalance which is the overriding concern of investors will be diminished and confidence restored.

We cannot count on the Federal Reserve Board to bail us out. Any substantial move on their part to shift gears to an accommodative monetary policy will rekindle the inflationary fires. The dollar will collapse against foreign currencies, and interest rates will soar.

Despite the temptation to compromise, it is essential that the Government play out what appears to be a "Catch-22" situation and that the inflation machine eventually be dismantled. At the expense of being overly dramatic, I think we could fairly say we are at the watershed of capitalism.

CONFLICT BETWEEN FISCAL AND MONETARY POLICY

I think the reason we are here is to explore why interest rates are so high. The papers are filled with panic stories on financing of the Government debt, crowding out, et cetera. I think we are now on a collision course between fiscal and monetary policy. What we have experienced in the post-World War II era is both stimulative fiscal policy and monetary policy. What we have now is restrictive monetary policy, quasi-restrictive at best, but stimulative fiscal policy.

Again, our obsession at FLA [Forstmann-Leff Associates] and the answer to your four questions about investment decisionmaking is largely related to inflation and perceptions of inflation in the capital markets.

COMPONENTS OF CONSUMER PRICE INDEX

I have enclosed some charts which I think you Senators all know, but they are interesting to review. The greatest enemy to capital markets and investment is clearly inflation. As chart 1[1] illustrates, 1967 is the base period at 100. Inflation is currently over 260. We have isolated by services, food, commodities less food. Again, it is a startling visual picture. Although the CPL line gradually moves in an accelerating direction, it is in the post-1973 period with the initiation of OPEC and, again, fiscal and monetary stimulus that the lines move up sharply.

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[1] See p. 183.

FEDERAL RESERVE SHOULD KEEP PRESENT POSTURE

One of my colleagues referred to the fact that the Federal Reserve should keep its present posture because, for the first time in recent memory, money supply is under control. Chart 2[1] is one that Milton Freedman provided, which is M_2 divided by real GNP versus consumer prices. For the first time since the late sixties, excess money looks like it is flattening out. It is either a coincidental indicator with prices or a lead indicator.

I think it is absolutely appropriate and essential that the Federal Reserve remain in its present posture.

INVESTMENT VERSUS CONSUMPTION

Chart 3[2] is one that concerns investment versus consumption, which is something that this administration really understands. The fact is that the United States has been a consumptive-oriented society at the expense of investment. We must compliment you on passing tax laws favoring the investment side of the equation. If we look at this chart, we can see that the United States in relation to the other OECD countries is an under-investor.

UNIT LABOR COST RELATIVE TO PRODUCTIVITY AND COMPENSATION

Another source of inflation over the years has been in the labor sector. Chart 4[3] compares unit labor cost, productivity and compensation. Here we can see that the 1976–80 experience with compensation per manhour running at 9 percent, unit labor cost per hour at 8 percent, and productivity at a mere 1 percent. We would suspect that incentives to invest would help alleviate this particular problem.

BOND-STOCK YIELD SPREAD

The next charts have to do with the capital markets. Since being a practitioner in that field, I would unequivocally state that the capital markets are in a precarious position. To some degree over the years, the press has let it be known that the markets have been positive for investors; this has not been the case.

Of particular interest to the U.S. Government should be chart 5,[4] the historical bond-stock yield spread in which Government rates have been pushed up to such high levels where we are at a paradoxically absurd point in the history of capital markets. In 1948 we also reached an anomalous position in which bonds were selling at a 2 to 3 percent rate. We are now at about 15 percent on long governments.

The problem with this chart is the bond-stock yield spread, which makes bonds so much more attractive, on a rational basis, than stocks, that one has got to suspect that the equity market will continue to decline, therefore continuously eroding the confidence in the administration.

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[1] See p. 184.

[2] See p. 185.

[3] See p. 186.

[4] See p. 187.

LIFE HISTORY OF A BOND

I think Wally Stern partically explained why interest rates are so high. One reason, of course, is inflation expectation; the other is that investors are products of their most recent experience. England has a bond called the consul, which was issued in the early years of World War II at a very low interest rate with no maturity date at 100. Those bonds are selling at about 8. The public lined up. Winston Churchill gave one of his brilliant oratorical addresses, and everyone bought the bond. Now they have $8 for 100 invested. The closest equivalent we have to an English consul is the Atchison-Topeka fours, given in reorganization in 1895. Chart 6 [1] shows the price history of that bond for the late 19th and 20th century.

I think it intriguing that in 1947 this bond sold at 140 yielding 2.54 percent. The bond is now all the way down at about 43. Ostensibly, what we are saying is what Wally Stern previously stated, that bondholders have unpleasant experiences. 1981 is the 34th year in which the bondholder has paid for what we call the inflation tax for social programs. And this bond, by the way, is not an unusual one. The line next to it is the average for corporate bonds. In fact, the only way to describe the bond market is a joke which was delivered in a European speech: How do you become a millionaire in America? You invest $2 million in the bond market.

IS THIS A BULL MARKET

Chart 7 [2] concerns again capital markets, specifically the equity market. The last time we were at a thousand, which was very recently, in April, were we in a bull market? Again, this is a chart I took from the Economist magazine, which tracked the Dow and deflated it by CPI. And we can see that at a thousand in April, the stock market was really at 350. So, if anything, the capital markets were in precarious positions prior to the new administration.

STOCK MARKET IN RELATION TO STANDARD AND POOR BOOK VALUE

The next two charts we can go over very quickly. Chart 8 [3] shows the stock market in relation to Standard and Poor book value. They were and they are today as low a valuation as they were in the early fifties.

STOCK MARKET AS A MEASURE OF BOOK VALUE

Chart 9 [4] is on replacement value. The stock market is selling 50 cents on the dollar.

WHY INTEREST RATES ARE HIGH

The last one which I think, if anything, would be my only minor contribution to the day, is why interest rates are high. And this chart was, oddly enough, presented by Dave Williams. He and I appeared together before the Washington Society of Security Analysts about 1 year ago. In fact, I think it was the day after the election. I introduced chart 10,[1] "Why Look at Alternatives?" This chart is the annual rate of return of a whole series of assets. I think it can answer your question why interest rates are high. The 11-year rate of return on bonds is under CPI. It is the lowest return on a group of historical assets, both paper and collectibles.

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[1] See p. 188.

[2] See p. 189.

[3] See p. 190.

[4] See p. 191.

I think what the administration has failed to comprehend is what is today the only meaningful economic theory, called rational expectation. Rational expectation is not a Keynesian school, nor is it monetarist. Actually, it seems to me, it is a behavioral science. What it suggests and what the administration has not grasped, is that the whole society is waiting for the Government to throw in the towel.

The question is, why the $155 billion in money market funds has not been allocated to more productive investments like Government bonds or the stock market? The answer is again that the burden of proof is on the Government, that it will not throw in the towel as it did in 1969 and 1970, 1973, and 1974 and fuel the inflationary machine. When the Government falters, the U.S. society has now learned how to cope with such under this theory of rational expectation. The assets they buy as inflation hedges are gold, silver, U.S. stamps, Chinese ceramics, rare books, coins, old master paintings, which may sound very esoteric and are clearly more suitable for upper income brackets. But the home, the one-family home is defined by us as the last vestige of bourgeois capitalism, especially on leverage and most suitable for middle income families.

So, I think that basically this is the present situation. Interest rates are high not only because of supply and demand. Rates only partially reflect confidence or a real rate of return. The Brookings Institution 9 percent secular inflation rate forecast would indicate that 12 percent should be the maximum rate for the Government, long-term bond. The 3-percent differential has to do with the theory of rational expectations and the failure of the investment community to believe the fiscal aspects of the government's attempt to reduce the deficit, which I think, unfortunately, is an impossibility for 1982.

Is there any question?

THROWING IN TOWEL WOULD BE NET RESULT

Chairman DOMENICI. You say you perceive that the expectation is that we will throw in the towel. You mention the Federal Reserve. What is throwing in the towel with reference to us? Aside from that, what are you referring to?

Mr. LEFF. Well, I think you people are doing a good job in continuously trying to trim expenditures, but the net result comes clearly from two sides. Revenues versus outflows. Now, concerning the original budget estimate for fiscal 1982 Wall Street does not have very much to do these days, and it depends who you poll: Henry Kaufman, bank credit analysts. It has almost become like an epistemological query of the Middles Ages, of how many angels can dance on the head of a pin, the size of the budget deficit.

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[1] See p. 192.

But, clearly, in the polling I have done with people who spend their time doing nothing but budget estimating, it looks like it is going to be $75 billion in deficit.

One of the anomalies of this situation is an assumption of a GNP deflator of 8 percent for fiscal 1982; disinflation actually penalizes the revenue side of the equation. In my opinion, I do not believe a high budget deficit at this point in time is particularly negative. After all, as Dave Williams said, it is only 2.5, or 3 percent of GNP. I think the problem is interwound in the politics of promising something which is generally heralded by the American public, that, if we balance the budget, we will have no inflation. That is a generally heralded thesis which I am not sure is correct.

In other words, let us say the budget comes in at $55 to $60 billion in deficit for fiscal 1981. If it is higher than that in fiscal 1982, confidence is undermined.

DECELERATING DEFICITS MORE IMPORTANT THAN BALANCE

Chairman **Domenici**. Just on one point, the point of managing the debt or the deficit, you conclude that we need further proof that we are going to do better each year in the future than we have in the past. Is that what you are saying?

Mr. **Leff**. Yes. I think the most important goal is decelerating deficits. I do not think balance is the important variable.

Chairman **Domenici**. I have a number of questions, but I think what I am going to do is go right into the Senators since they have some questions. We will start with Senator Grassley, and then we will move in the order that you came, Senators. Senator Grassley?

TAX CUT'S IMPACT ON THE DEFICIT

Senator **Grassley**. What about the tax cut? The tax cut is certainly a revenue loss that adds to our budget deficits, and this could be construed as a negative signal to the financial community. We assume however, that cutting marginal tax rates will increase the savings pool, hence the Federal Government's borrowing is going to be a smaller percent of that total pool of saving and investment. Is that not going to have a beneficial impact? Shouldn't that counteract the adverse market expectations of the tax cut's impact on the deficit?

Mr. **Williams**. Yes, sir. I think what you say is correct. I would just remind you, however, that the marginal tax rates really do not start getting cut for nearly a year from now. I mean, yes, we get a tax cut in a few days, but it is immediately offset by bracket creep and the social security tax increase. Therefore, the marginal tax rate cut to which you refer is well into the future. It has not happened yet, and we will not see the effects of it until a year from now.

I think the way you describe the outcome is quite accurate but, again, time, patience; we have got to wait for that to happen.

Senator **Grassley**. Would you care to respond?

Mr. **Stern**. Yes, Senator. I agree with what was said. I think it was very favorably received, but the effects are going to be long-term effects; and we are dealing with the short term in terms of financial markets. Whether that long-term effect is enough to change inflationary expectations and expectations of budget deficits remains to be seen. We know where we are now. With the best of forecasting, nobody knows for sure how that is going to work. But, in summary, it is a long-term effect contrasted with the short-term problems that we are facing right now.

Mr. **Leff**. That is, at the expense of being redundant, exactly correct, long-term positive effect. However, the capital markets deal in short-term phenomena. The problem with the markets from the Government's point of view is the fact that, due to 15 years of accelerating inflation, the maturity of the $1 trillion Government debt is less than 3 years. So, if you want to make an assumption, a prima facie case, no further deficits, the Government is still financing about $330 billion a year. And that is the short-run problem.

RECONSIDER AND MODIFY TAX POLICY

Senator **Grassley**. You suggested in your statement that it is essential that tax policy be reconsidered and modified. At a time when we are discussing signals to the financial community and to the country at large, it seems that this would do more harm than good.

Mr. **Leff**. I think the word "reconsideration" I tried to make as broad as possible since I am not a tactician in taxes. I think the point is that you have to impact the revenue side of the budget.

The problem is as follows: If we all believe the Federal Reserve must pursue a restrictive monetary posture—and I think we all can concur with that—we will probably wind up in a recession this year. This means that you are again overestimating the revenue side of the equation. If you add to that declining inflation, the budget deficit—I do not care what you cut, I mean unless you are going to eliminate defense totally. We are dealing with figures like $75 billion. Where are you going to cut $50 or $60 billion? I do not see the possibilities without jeopardizing a legitimate Government and a moralistic society.

I do not see where you can get the numbers I am referring to from any other source but modifying the tax cut, Business Week suggested a VAT tax. It works well in Europe. It might work well here. I cannot speculate on what kind of taxes are optimum. I would say I think the legislated tax cuts are too stimulative at this point in time.

Senator **Grassley**. You are saying our tax cuts will be too stimulative?

Mr. **Leff**. Yes. By too stimulative, they are too large. It is $750 billion over a period of 3 years. I think that might be overly ambitious.

Senator **Grassley**. Do we have crowding out in the credit markets at this time?

TAX INCREASE WOULD BE DEVASTATING FOR CAPITAL MARKETS

Mr. **Williams**. Could I comment on the question you raised previously? I think that any effort to raise taxes, particularly taxes that are based on income or earnings, would be devastating for the capital markets. I think it would be a signal of a return to the tax, tax, tax, spend, spend, spend policies of the last four or five decades. It would be totally disheartening. It would be giving up on the effort to cut marginal tax rates before we even saw what effect they might have. Any increased taxes that relate to income or earnings, I think, would be a very unfortunate shift in policy.

Mr. **Stern**. I would endorse what Dave Williams has said. I think the problem is how you change the perception of a large deficit. I would think that any effort to change those tax cuts would raise uncertainty as to the direction of the Reagan program and not be well received. As a minimum there is surely some feeling that they might be postponed if left in place. I personally would not favor that. But I would be very careful on sending out any signals, as you suggest, which give any whiff to Wall Street that there is a change of direction in sight.

I would much prefer to see you address the deficit by further budget cuts.

PEOPLE MUST BE PATIENT

Senator **Grassley**. This question is for whichever one of you gentlemen addressed the fact that—and I do not dispute it—there aren't just a few people on Wall Street making decisions that cause the economy to do well or badly. Unfortunately, that is not the perception of the public at large. If you were to get out in the grassroots with us, you would find that the people are convinced that only a few key money people in this country are making those decisions. I think it has something to do with whether or not the people are going to be patient. Who said that the people must be patient? I made that statement back in February in a speech in Iowa when I said that the President's biggest job during his term of office would be to teach patience to the people of this country. We were then going into the budget decisions that I was not even sure would be made and since have been made beneficially. I sense, however, that they tend to be a little more impatient now than they were then.

We have made a lot of decisions that I think would cause people to be less impatient. Somehow it relates to the fact that there are a few people on Wall Street that are putting the squeeze on for their own selfish interest.

But my point is—I am not saying that because I do not believe it either—that we have got to do something if we are going to win this battle and have the patience and have the credibility not only in our financial system but in the Government as a whole and the institutions that control American society. We have got to do something about it.

SHRINK SIZE OF GOVERNMENT RELATIVE TO ECONOMY

Mr. **Williams**. My response to that is that the thing to do is to keep doing the right thing, which to my mind is trying to continue to shrink the size of Government relative to the economy, and to do it with persistence and regularly and without wavering and to try not to be too distracted by the daily fluctuations of the stock market or the bond market. If the right policies are pursued steadily and diligently, the markets will eventually come around.

Senator **Grassley**. You know, what you are talking about really is not a few statistics. You are talking about having Government policy impact beneficially upon people's spending and saving habits that have developed over the last 25 years.

Mr. **Williams**. I think we have all said it. The new policies are trying to break habits that are anywhere from 20 to 50 years old in terms of what people think about the future, what they think about inflation. It is not going to happen in a few months. It is a several-year process.

PARTNERSHIP BETWEEN PRIVATE SECTOR AND GOVERNMENT NEEDED

Senator **Grassley**. I will close with this statement, but I hope that people on Wall Street do not feel that only Government can help bring about these changes. There has got to be a partnership between the private sector and Government to bring about these changes. We can have a dramatic impact upon them, and obviously we are trying to change those policies that have detrimentally impacted in the past so that they beneficially impact in the future. But somewhere along the line there has got to be a partnership of trying to carry the story to the people at the grassroots. It is not going to come just from those of us who are elected to public office even though we can be helpful.

Chairman **Domenici**. Thank you, Senator. Senator Chiles?

MARKET REACTION TO DELAYING TAX CUTS

Senator **Chiles**. Thank you, Chairman Domenici. Mr. Williams, you stress the need that we cut Federal spending, which is what most of us on this committee have been trying to do for a number of years now. You talk about the patience that needs to be applied.

Given the fact that we have cut $35 billion and that many of us here felt that the estimates we were using were overly optimistic, and that we were trying to raise defense spending, as well as have a tremendously large tax cut and make spending cuts in the range of $35 billion, we still were not going to be able to balance the budget. Now you are telling us that we have got to be patient. Should not or could not that patience apply to the joy of some of that tax cut as well as the joy of some of the spending cuts?

However, we are not going to be able to cut $100 billion. I think, if you are really listening, you will see Chairman Dole of the Finance Committee say cutting $100 billion is impossible. Chairman Domenici of the Budget Committee also says that is impossible. I even think Majority Leader Baker has said that is impossible. Those are the Republicans in the Senate, saying we are not going to be able to make it before you even get around to any of us Senators over on the Democratic side. Chairman Hatfield, the chairman of the Appropriations Committee of the Senate, has also said that.

But if balancing the budget is as important, and maybe it isn't, as Mr. Stockman says, then how is Wall Street or the market going to react if you say we are going to have to delay some of those tax cuts?

As Mr. Leff has pointed out, tax cuts can be just as stimulative as the deficit spending we used to do, especially when it is a tax cut written in red ink, and that is what this tax cut is, all in red ink.

For the life of me, I do not see—well, there is just not any way we are going to make $100 billion in spending cuts.

You can mention what we ought to do in social security, but I think you are seeing what is happening there; that is not going to be cut. Defense, according to the administration's figures now, is going to be just nicked and not cut either.

So, if you take these proposals, and when they come from the Republican side, you know, I think you have to take them as being realities—then it seems like to me, unless you do something on the revenue side to hold back some of those cuts for a period of time, you are not going to reach a balanced budget.

TAX CUT DELAY VIEWED AS RETURN TO PAST POLICIES

Mr. WILLIAMS. If I may respond, I think that delaying or lessening the tax cut would be viewed by the capital markets at least as a return to the policies of the past, which is to say we will stay on treadmill of trying to use bracket creep to balance the budget. The markets would see this as a return to a path toward higher peaks of inflation cycle to cycle. I think our best hope of breaking that psychology is just the great discomfort that undoubtedly you and some of us in the capital markets are experiencing. We do have the clash and conflicts that you describe in the short term of building defense, cutting taxes, and trying to shrink the deficit. The pieces do not fit together too beautifully in year No. 1.

But, I do not think the markets expect a miracle in year 1 or even year 2. If the trend of things is toward a lower deficit, I think the markets will in time respond positively.

BALANCE IN 1984 OR CONTINUED DEFICIT

Senator CHILES. Well, if you do not delay the tax cut or do something else on the revenue side, and given the hypothesis I just set up—that we are not going to make $100 billion in spending cuts—then what happens if you make—you know—then the only way I see that we can balance the budget by 1984 would be to enact a combination of some further spending cuts and combining that with some kind of revenue package.

Now, you tell me how the market will perceive that. Would it be better if you close the loop by doing that and have a balance in 1984? Would it be better if you have a $75 billion deficit? I do not think that without doing something on the revenue side you are going to get more than about $25 billion in additional cuts over that period of time. So, which would be better?

Mr. WILLIAMS. I would opt for the latter——

Senator CHILES. You may get it.

Mr. WILLIAMS [continuing]. On the expectation and hope that we will experience some acceleration of economic growth beginning, perhaps, in 1983, when the marginal tax rate cuts begin to affect the economy. So, I would bet the latter course.

SPREAD BETWEEN INFLATION AND INTEREST RATES

Senator CHILES. Mr. Stern, there has been a lot of discussion about the spread between the inflation and interest rates. What other factors are causing high interest rates? It would seem to me that, with the tremendous uncertainty about the impact of the tax cuts and the size of future deficits, there is likely to be an uncertainty or a risk premium involved.

Do you think that is happening now?

Mr. STERN. Well, sir, it certainly is happening, and I could not state it any better than you did. The spread is caused not only by current inflation but by expectations of future inflation. At the moment, the uncertainty on what future inflation and, to go back to your previous question, the size of future deficits may be are impacting buyers' willingness to buy long-term bonds. It is, clearly, the uncertainty and inability to predict either size of future deficits or the impact on inflation which is causing this currently unprecedented spread between the current rate of inflation and the interest rate demanded by buyers of long-term bonds.

That perception is subject to change. I think that one of the parts of it is the perception that the Government is holding fast on trying to change the role of Government in the economy by bringing down taxes and bringing down spending. However, to go back to your previous questions, there are surely mixed views on Wall Street on the question that you asked as to whether the Street would prefer to see some kind of postponement of tax cuts. It is not a unanimous view. I happen to subscribe strongly to Dave Williams' view.

RISK FACTOR WITH RATES

Senator CHILES. Is there any way to quantify what you think that risk factor is: say, 1, 2, 3 percent? Do you have any estimate?

Mr. STERN. The historic real return has been somewhere generally quantified as around 2 to 3 percent. Since we now have a current rate of inflation of something in the area of 10 percent—some may say 9 percent, some may say 11 percent—and long-term bonds are yielding 16 to 17 percent, you have about a 4 percent, give or take 1 percent, extra risk premium caused by uncertainty about the future. And that is extraordinarily large.

Senator CHILES. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Kasten?

POLITICAL CRISIS OCCURRING

Senator KASTEN. Thank you, Mr. Chairman.

It is frustrating to sit here and listen to the economic questions because there is more of a political crisis today than an economic crisis. We are discussing this, but things are going to go along and life goes on. Within the last 10 days I have talked to two or three car dealers who are out of business. The reason that they are now former car dealers is because of interest rates, both the cost of floor-planning the cars and the problems of financing cars on behalf of a purchaser.

What is interesting to me is that at least two of the individuals I have talked to in the last 10 days, said the same things that Dave Williams just said a minute ago; and that is stick with the plan. It is incredible when you think of a person who is out of business coming to you and saying stick with the plan; it's going to work somehow; we've had some good years; and the plan is going to work.

We have got a political crisis coming even though we might not have an economic one. With the way the market has been going so far this morning, maybe we could have an economic one by the end of the day. But there is a political crisis that is occurring. We have a window of opportunity, I think, a new Senate, a new President, a new idea. We got 90 or 95 percent of what we asked for in budget and tax cuts the first time through. And the results are substantially different from what the average working man and woman who voted for us thought they would be at this point. So, although there is not an economic crisis, this window of opportunity is coming closed, and we have got a political crisis. We can see it. We can sense it. Conservative Republicans as well as others are saying, is it time to jump ship, or should we stick with the program?

Now, the fact is, if we jump ship, there is no hope. And I think that is what has come out of your discussion this morning. But is there a way we can get results we can at least point to and say: you are better off because of this. And this committee and this Congress and this Senate and this Senator want to do that. We are willing to cut defense more. I appreciated the comments of Mr. Williams on a couple of defense projects. We are willing to cut entitlement programs more.

I think if there is one chart that says it best, Mr. Chairman, it is the last chart of the Williams' testimony in which you see what has happened with various kinds of indexed programs. I think there is no question but that we are going to have to take a look at the CPI for indexed programs. But, if there were one thing that we could do, would it be to cut these programs? I think we can. We still have the consensus. What one thing would you recommend? We will start with Mr. Williams.

RENEWED ASSAULT ON BUDGET RECOMMENDED

Mr. WILLIAMS. I would recommend a renewed assault on the budget.

Senator KASTEN. In any specific areas?

Mr. WILLIAMS. Well, the ones that I named, but I think there are a lot of others, too. One area of the budget that so far, to my knowledge, has not received a lot of scrutiny is—pardon me for saying so in these hallowed halls—the number of Government employees. I think it is highly symbolic; at least in business, when one is trying to cut costs, you do something about the payroll.

I remember an interview with Mike Blumenthal in a Fortune magazine shortly after he resigned as Secretary of the Treasury. He was kind of laughing about this problem of the Customs, that here was a mere few hundred million dollars of wasted money. You know, do we really need a Customs Service? It is apparently one of the many responsibilities of the Secretary of the Treasury. Yet, it was such a small number, being merely a few hundred million dollars, that no Secretary of the Treasury was willing to pay the political price to fix something that is an obvious symbol of waste and lack of necessity in Government services.

Why not go after some of these small items that I think would be fairly symbolic to the population at large? There must be thousands of them in a budget of $700 billion; there have got to be a lot of unnecessary people.

Senator **Kasten**. I think it is important to recognize that the President is recommending a cut of roughly 75,000 Government employees. If we are successful in putting some more of these categorical programs into block grants, that is another whole level of cuts in staff. Also, the speeding up of the dismantling of the Department of Energy and the Department of Education is going in this direction. I think there are a number of programs which many of us will support and intend to support, but I appreciate your suggestion.

Mr. **Williams**. I think you are going to get one reward that will become obvious in a few months. Finally the Consumer Price Index will begin to reflect the reality of a lowering inflation rate. I think you will have a symbol to point to.

Senator **Kasten**. Mr. Stern?

Mr. **Stern**. I understand your question. It is a good one. What can you point to? I can tell you the things you should not do. Unfortunately, it is a little more difficult to tell you the things you should do.

I would pay no attention to some of the talk asking for immediate turn to the gold standard. I do not think that is understood by Wall Street. And I do not think it is going to present any immediate solution.

I would tend to feel, contrary to at least one of us, that raising taxes is not the answer.

There is one area which was widely rumored before the President's speech last Thursday—namely an import tax on oil; my guess is, if you are going to look for one big revenue measure, that might be accepted because it could be justified by reasons other than as a tax measure. That is, there are national security or other valid reasons (perhaps the move toward energy independence) on which it could be justified. It might not be well received but it would be less poorly received than any other tax.

I would not like to see a value-added tax. I would like to see a renewed attack on the budget. I think there is a general feeling on Wall Street that social security is politically untouchable; whether that is right or not, you all can tell us better than we can tell you.

I think there is still a feeling that there are major cuts that could be made in the defense area and some unhappiness with the continued assertions that there are no more areas that can be cut in that area.

I do, lastly, think you are going to get some good news, as Dave does. I think the rate of inflation is going to slow down as the economy slows down. I hope that will get a lot of publicity because you sure do need some symbols of "success" and I recognize that.

REVIEW ENTITLEMENT PROGRAMS

Mr. **Leff**. I guess I have to agree. I think entitlement programs probably should be reviewed again. I think that you do have the improvement in inflation going for you, and you will start to see that in the next few months.

Again, I am not necessarily advocating an increase in taxes, perhaps an indexing or a postponement of one, again to bring the deficit more into what was announced as the political objectives.

PEOPLE COMMITTED TO STICKING WITH PROGRAM

Senator **Kasten**. Your response, Mr. Stern, reminded me of when I used to be in the minority. You could walk in and vote no and lose and walk out and not take any responsibility. Unfortunately, times have changed. We now have to say things that we are going to do, not just things that we should not do.

In conclusion, Mr. Chairman, I would have to say that I am optimistic. There is a lot of doom and gloom floating around, but I really believe that we do have the consensus of Republicans, Democrats, liberals, and conservatives to stick with the program. I think people are going to start to take potshots at us, but I think that there are enough people who are committed that it is going to keep going. If we can see inflation coming down, if we can see the Consumer Price Index starting to move down, I think even a two- or three-point drop in interest over the next couple of months is going to be a trend in the right direction.

I think we are going to see that. I hope we are going to see that. I hope that we do not give up on the tax cut. I hope that we do not stop the efforts that we have got to continue to make on these spending cuts, especially in defense and the entitlements.

I think the consensus is still here. It might not look that way in the editorial and op-ed pages of newspapers, but I think out in Main Street America and, I believe, in Wall Street as well, as one of your testimonies pointed out, that it is a whole lot better when you are talking to people than it is when you are reading about what people are supposed to be saying. It is important for us to keep talking with people and seeing people.

We look forward to working with you.

Thank you, Mr. Chairman.

Chairman **Domenici**. I thank the Senator. Senator Exon?

BALANCE GOVERNMENT INCOME WITH SPENDING

Senator **Exon**. Thank you, Mr. Chairman.

Gentlemen, I appreciate very much your coming here today. I wish that I could share the optimism of some of my colleagues on this committee. I am optimistic by nature. But, frankly, I am scared of what is going on today. And I am not here to fix responsibility or blame.

I was a little bit surprised the other night when the President said his programs were not working, of course, because they did not start until next week. That is this week. Now, you know, I know, and everybody else knows that there is not going to be any significant difference to the good on Friday next than there is today. Therefore, I only focus in not to wave a flag but to wave a caution signal, if you will. I think we are in a very, very difficult position.

In my opinion, while we have long-term concerns about inflation, which are justified—and I have been working with the other members of this committee on both sides of this table for the last 2 years to reduce Federal expenditures and hopefully to affix our eyes on a balanced budget; 1984, in my opinion, is the quickest we can do it. I think we better keep our eye on that.

I think, regardless of all the talk, you would all agree that, unless we get the income balanced with outgo in the Federal

Government, sometime in the future we are going to have untold and continuing difficulties.

PRIME INTEREST RATE

What is facing my people in Nebraska today, and I suspect the major concern of most others, is the crucial critical matter of high and confiscatory interest rates. In my opinion, unless they are curtailed they are going to cause the Reagan economic program to fail.

Let me put it to you this way. Given the realities of the situation, not the way we would all like to have it, but given what you each feel are the realities of the present situation, what do each of you estimate that the prime interest rate will be—and I identify that as the widely held prime at 19.5 percent right now—what do you predict that interest rate will be on January 1, 1982 and July 1, 1982, given the realities of the situation as each of you view them? I would like to start out with Mr. Leff.

LOWER INTEREST RATES PREDICTED

Mr. LEFF. Not at the expense of being evasive, I would hate to give an interest rate prediction because I have found in the past people who predict interest rates, the prediction tells you more about the forecaster than the future.

Senator KASTEN. Can you tell us whether you think it is going to be higher or lower than now?

Mr. LEFF. Lower.

Senator EXON. How much lower?

Mr. LEFF. It is hard enough to guess on direction, never mind extent.

Senator EXON. Mr. Stern?

Mr. STERN. Like the others, I do not think the predictions are worth a damn; but, if you accept them as that, I think it depends how much pain we have between now and year-end. I think there is going to be some pain, as Senator Kasten points out, for examples, with car dealers. I think short rates are going to be probably 2 to 3 percentage points lower by year-end and trending down again by the middle of next year.

Senator EXON. So, if I interpret you right, you think that the interest rates could be down to 17.5 or 16.5 percent by year's end and then on down next July below that?

Mr. STERN. Perhaps by a like amount by the middle of next year.

Senator EXON. Like amount by the middle of next year.

Mr. STERN. But I have very little confidence in that forecast, and that is one of the problems facing Wall Street at the moment.

Senator EXON. You say you have very little confidence in your own forecast?

Mr. STERN. I have very little confidence in my own forecast, and I do not find any other forecaster that does. It is a period when it is very difficult to predict because of the uncertainties of what is going on in the economy and what is going on right now here in Washington.

Senator EXON. Mr. Williams?

Mr. WILLIAMS. With the same caveat about forecasts, I see the interest rate future much as Mr. Stern does: A 200- or 300-basis-point decline in each of the next 6 months.

Senator EXON. I appreciate your answers. I know it is very difficult for you to be precise. Certainly, I realize that the markets are not indicating that. The future markets on T-bills, for example, are not bearing out your predictions at all, are they?

Mr. STERN. That is correct.

Mr. WILLIAMS. That is very comforting.

Senator EXON. When you say that is very comforting, are you being facetious?

Mr. WILLIAMS. I am being a little facetious, yes.

LOWERING INTEREST RATES IS STEP IN RIGHT DIRECTION

Senator EXON. Gentlemen, it seems to me that, not only are the automobile dealers in trouble, and, as important a section of our society as they are, they do not have the direct effect on other sectors of our society that also are literally being killed by high interest rates. I speak of agriculture, and I speak of the homebuilding market, the real estate market, the lumber market, and all that goes with it. Not only are we seeing increasing numbers of bankruptcies in these fields and those allied with them, but I say to you in all sincerity, unless we can somehow get down the interest rates dramatically to the point that Mr. Stern indicated that he thought they might be—and, if they come down that much by that time, it is going to be a step in the right direction. But, unfortunately, I think you are overlooking the fact that I am not sure that our overall economy will be able to stand those sustained high interest rates for another 6 months or another 6 months beyond that.

So, while I hope that it comes to pass, I am afraid that all too much of our economic thinking today is based on hope and wishful thinking rather than the realities of the situation.

I have no further questions. I thank the panel for coming and I thank the chairman.

ESTABLISH BETTER CHANNELS OF COMMUNICATION WITH FINANCIAL MARKETS

Chairman DOMENICI. Thank you very much. I have a few questions.

First, let me thank all three of you. I greatly appreciate your coming. Mr. Williams, I can tell you as chairman of the committee we will accept your kind suggestion and admonition that we establish better direct channels of communication with people like you. I would like you to know that, while we have not had panels such as yourselves regularly here, I think individually and at the staff level we have been pretty much in touch with what is going on. I think you should have some evidence of that the last time we met with the Chairman of the Federal Reserve. With few exceptions, I think it was generally a rather enlightened question-and-answer session. I think, if you follow hearings, you will find that a compelling majority of this committee chose not to lay blame on the Federal Reserve Chairman for all of this nor to assume that the quick and easy fix was to get rid of him or that which he stands for.

I think there was a general consensus as one listened that we were talking about a situation that was not going to get cured immediately.

Having said that, let me also thank you for what I think is, from all three, a very succinct appraisal of the money supply situation. You indicated with the abolition of some of the regulatory inhibitions on interest rates such as Q and others that we now have a closer proximity to supply-demand in the marketplace than we had in years past.

DISPARITY BETWEEN CPI AND INTEREST RATES

I also want to thank you for another effort on the part of people such as you to explain the rather strange phenomenon that we had 3 or 4 or 5 years when the bond markets and the money markets responded to the promises of lower inflation, the promises of fiscal restraint, only to find it did not work. It is rather interesting to trace the disparity between CPI and the level of interest rates were during 3 or 4 years very similar to this but for regulation Q and others and find that there is a 2-point spread, maybe 1½. It got as high as 3 points. And everybody is jittery because there was a 3-point spread between CPI and the interest rate.

SUPPLY-DEMAND AND INVESTING IN LONG-TERM BONDS

You have concluded, if I understood, all three of you, that the supply-demand situation plus the fact that investing in long-term bonds and the like was not a good place to place your money in the past and that realization has set in now, and that is not going to happen any longer. If I read you, all three of you have said that unequivocally this morning. Am I correct?

[Messrs. Williams, Stern, and Leff nod in the affirmative.]

Chairman DOMENICI. All of that sooner or later has to sink in, and we have to begin to understand that there is no quick and easy solution. Certainly, the solutions in the past were the wrong ones. Each of those times when we had good interest and bad fiscal policy, we came along and primed the pump. I think you can trace that for me, and we found that has occurred two times in the past 6 or 8 years.

On the other hand, let me try to put into perspective—I do not have the leisure at this point for a while to share with you specifically my solutions because I think we have to wait for a little bit of an evolution here in the Congress and with the White House on how we are going to do this. But I have a couple of concerns that I want to share with you. Perhaps you can give us some advice.

LOWER LEVELS OF TAXATION AND GOVERNMENT GROWTH AND SPENDING

All of you indicate that this is a long-term problem that requires patience. I do not think anybody disagrees with that, a slight difference in opinion of what you would do on a mix of deficit reduction actions at this point. But I think what we are trying to say to you all, those of us who support the concept of lower levels of taxation than has historically existed here and significantly lower levels of Government growth and spending than have existed here, I think what we are suggesting is that that is our long-term goal. As I understand it, all three of you agree with that.

On the other hand, we have a short-term problem, you all say, a short-term problem that we have to get through. Now, whether it is the bird that landed in the decrepit steeple that one of you used or whatever, we have a problem of getting out of the short-term problem and keeping the program that I just described, of significantly lower levels of taxation on the American people, and significantly lower levels of expenditures, of keeping that alive during this short-term crisis. That is how I see the problem.

We will still have those long-term qualities that I just described, if we can get through the next 18 months or so, in terms of doing some things.

CHANGES IN THE CPI AND ENTITLEMENTS SUGGESTED

On the other hand, you all are saying to us the solutions should be long term, not short term. You were suggesting such things as changes in the CPI, entitlement—not entitlement cutbacks but slowdowns in the growth. Those all are long term. Nonetheless, if I read you, we have got to put some of those in place now for credibility purposes. Is that correct? Would you all answer that one first?

[Messrs. Williams, Stern, and Leff nod in the affirmative.]

Chairman DOMENICI. So that is why you are not so concerned about 1982, but you would be concerned about 1982 without some 1983, 1984, and 1985 in-place actions that would reduce the apparent disparity between revenues and expenditures. Is that correct?

[Messrs. Williams and Stern nod in the affirmative.]

CUT MORE FROM DEFENSE

Chairman DOMENICI. All right, if that is the case, and we have to give evidence of long-term solutions but do it rather quickly, the only person that has addressed the issue of some change in the tax package on the affirmative side has been Mr. Leff. He analyzed it very quickly and said you are not going to cut enough out of defense; I have looked at the major areas where you should cut; and I hear you are not going to cut enough there; so, there is not enough left over.

Do I read you right?

Mr. LEFF. That is correct.

Chairman DOMENICI. What do you say about that, Mr. Williams?

Mr. WILLIAMS. Well, I disagree. I think that there are more opportunities for budget reduction, that perhaps I am just unaware of the——

Chairman DOMENICI. Well, why don't you and I talk about them? You have talked about defense. You indicated that you are not just an official in your firm but that as part of that work you have to look at a military budget. If you know what you are talking about, what you read to us—and I have no doubt that you do—you are rather well versed. And you get that from what you consider to be good sources.

Without going into detail, how much more can you cut out of defense in 1983 and 1984?

Mr. **Williams.** I think in the area of $10 to $15 billion per year.

Chairman **Domenici.** In——

Mr. **Williams.** From current plans.

Chairman **Domenici.** In outlay expenditures per year?

Mr. **Williams.** Yes.

Chairman **Domenici.** So, if we took your low number, you would say $10 billion plus $10 billion is $20 billion plus—I assume you agree that——

Mr. **Williams.** $5 billion.

Chairman **Domenici.** $5 billion would be max because you are into the year.

Mr. **Williams.** Yes.

Chairman **Domenici.** So, you are talking about $25 billion?

Mr. **Williams.** Yes.

Chairman **Domenici.** OK. Where do we get some additional significant cuts?

Mr. **Williams.** Outside of defense?

Chairman **Domenici.** Yes; we have done that now.

ENTITLEMENT PROGRAMS NEED TO BE CUT

Mr. **Williams.** I think we have got to go after the entitlement programs. I do not have a number here but, just looking at the size of them, one presumes that something on the order of perhaps half as much as you just cited on a 3-year total for defense would be available by simply a modest slowdown in the rate of gain of the value of benefits paid in these next 3 years, that a very modest slowdown of simply 2 percentage points less than the rate of inflation or something on that order of magnitude would yield in the area of $15 billion versus current plan over a 3-year period.

PENSION PROGRAMS

Chairman **Domenici.** Very close. Two percent less than CPI guaranteed over the next 3 years for just the pension programs. And there are far more entitlements than that.

Mr. **Williams.** That is just a big obvious one.

Chairman **Domenici.** Three percent would yield about a $35 or $38 billion saving. So, you said 2 percent, so you are in the ballpark on that.

Mr. **Williams.** I am a little low probably.

Chairman **Domenici.** But, if we add that up—and let us go on the high side of yours—that is another $20 billion. Plus your $25 billion.

Mr. **Williams.** $45 billion.

Chairman **Domenici.** $45 billion.

Mr. **Williams.** And the other entitlement programs are very difficult for a nonexpert to analyze because they do not lend themselves to the math of the big pension plan. So, I really do not have a number there. But a guess—and I do mean a guess—is something on the order of $10 billion over a 3-year period.

Chairman DOMENICI. I would agree with that. Let us put that down. In fact, that is a pretty mild suggestion. So, we are up to $55 billion.

EXCESS GOVERNMENT EMPLOYEES

Mr. WILLIAMS. And then there is the matter of what I would call excess Government employees that I would tend to judge are in the area of 100,000 in number. The cost of an average Government employee must be $25,000 or $30,000 a year.

Chairman DOMENICI. Yes.

Mr. WILLIAMS. Something on that order. And I believe that gets you, say, another $30 billion per year. As the person who this building is named for said, a billion here and a billion there.

Chairman DOMENICI. Well, that one's—you have been right on in terms of both doability and real commonsense, but the $30 billion a year on Federal employees is—that is out of the question. But, if we keep talking about it, it—you will not save that much, and it cannot occur.

A number of those savings will be occurring in the programmatic changes that you talk of. When you lump those programmatic savings, you get some of those people, too.

But that would be 90,000 if you had—you know, if that was a credible one. We would be home free. We would not have to look at anything else. Ninety plus—you said $3 billion per year?

Mr. WILLIAMS. I am trying to do the math here as I talk with you, and I think I am losing decimal points.

Chairman DOMENICI. You did not have your calculator. It is $3 billion, not $30 billion.

AGRICULTURAL PRICE SUPPORTS

Mr. WILLIAMS. Too bad.

Another area that I think—here again I am ignoring the politics, but agricultural price supports.

Chairman DOMENICI. Well, if we can get the milk price supports down where the Senate put them, the wheat support down which is down, the other items that came through the Senate, that will be the largest real curtailment in decades. The problem is that that is a good-news-bad-news situation because we are going to have incredibly good crops, which all of you love because that means the consumer should be paying less, and they will, but we will pay more for these programs. It is sort of like OPEC: you get a little less windfall when they freeze the price, but no one wants the extra windfall profits, to put you back on 30 percent a year on crude oil. I think we all would take a little less in taxes for what that contributes.

Well, let me just end this up saying, you know, on that score I would hope that you would continue, regardless of your slight difference in opinion as to the mix, to recall one thing and do what you can to help. The biggest mistake we will make because of the short-term crisis in interest and all of the bad things it brings, is to get off the real path and say there is an easy way to solve this, like cutting off $100 to $150 billion of the tax reductions, and go home and say we all won.

Remember, I am talking about some suggestions that would just say we do not have to cut anything more, just reduce the level of taxation of those cuts by raising $100, $140, or $130 billion.

I hope you would agree with me—I hope you would, Mr. Leff, that that is not the kind of thing you were talking about. That dimension would say then that we do not even have to worry about fiscal policy again; we have solved the problems. I really think you all would agree that is wrong, would you not? How about you, Mr. Leff? Would you agree with that?

Mr. **Leff**. Yes, I would agree with that.

REVENUE RAISERS

Chairman **Domenici**. Yes, I would think you would.

Since we have got everybody's ideas that we want to move with fiscal restraint, and we have had some specifics bandied around, let me ask this. Of the tax proposals for the raising of revenue, what revenue measures should be considered from your standpoint consistent with what we want to see happen? What revenue raisers should be addressed first? Even if you do not like them, if the practical effect is that you have to, what would you address first? Let us start with you, Mr. Williams.

OIL IMPORT OR ENERGY EXCISE TAX

Mr. **Williams**. I thought Mr. Stern's comment about an oil import tax or simply an enlarged excise tax on energy is the most sensible one that I could come up with, either imported oil or all energy.

Chairman **Domenici**. Even though it is inconsistent with your philosophy and your good analysis here, could you go beyond that and give us even some generalizations of what revenue raisers should look like and what character should they have if we are going to raise revenue?

Mr. **Williams**. I think they should all be of an excise tax type rather than a tax on income or earnings. I think one of the Nation's still pressing problems in spite of the very considerable progress made to date is the level of oil imports and the overall level of energy usage. Therefore, a logical conservation-aiding excise tax would be a tax on gasoline, an X-cents-per-gallon tax on gasoline, or an X-dollars-per-barrel tax on imported crude oil.

Chairman **Domenici**. You have heard some suggestions that the oil and gas taxes that were put in the last bill, tax reductions in long-term windfall profits and the like, should be adjusted. Would you address that one?

TAX CONSUMPTION NOT PRODUCTION

Mr. **Williams**. It seems to me that the application of taxes on the earnings of corporations or individuals is a step in the wrong direction. Therefore, I would try to remove rather than add back any kind of, quote, windfall profit taxes or taxes on profits made from energy production. I think that is going in the wrong direction. We should tax the consumption, not the production.

REVENUE RAISERS PRIORITIES

Chairman DOMENICI. Could we move over then? Mr. Stern and Mr. Leff, you have heard the discussion. Could you for me and for the record here tell us? If you had to raise revenues, what qualities would you attach to those revenue raisers to remain on the most consistent path as possible?

Mr. STERN. I will not repeat what Dave Williams said. I would endorse word for word his priorities. The only new thought I would add is that I do not want to touch the structure of the tax cuts. I think if you still want to make some changes there, perhaps a postponement would be the least onerous.

I agree strongly with the comment on excise taxes, not touching the basic structure. And I think a tax on imported oil is probably the most palatable at the moment because it could be justified for other policy objectives.

Mr. LEFF. As I think I said before, a postponement or indexing would be the optimum, if not excise, clearly, I think what you want to do is to orient efforts toward consumptive taxes as opposed to investment. In this area I would agree totally with my two colleagues.

PATH OF GOVERNMENT EXPENDITURES

Chairman DOMENICI. Let me ask you one last question. Aside from the idea that we ought to have a balanced budget by 1984 and be on some path that moves in that direction, if $30 billion additional in cuts were effected in 1983 and we knew they were in place and $45 billion in 1984, the path of Government expenditures would be as follows: The previous 4 years, increase per year, 13 percent a year, Federal budget increase. You would then be on a path by 1984 where you are increasing at 5.7 percent a year.

I would just ask you this. In light of the testimony you have given to us, it is my understanding that, if that was the reality and in place, most of the concerns that you have that can be cured by fiscal policy would have been addressed. Is that a fair assessment?

Mr. STERN. Accepting the caveats that you placed on it, yes, indeed. I think there has been entirely too much attention to the size of the deficit this year and to the zero objective. I think, if that trend is in place, it would indeed be reasonably accepted by financial markets. You put some pretty good caveats in there, and I am not sure how we get from here to there; but at the moment we are in an environment in which most reasonable analysts are unable to substantiate whether the deficit is going to be zero in 1984 or $100 billion in 1984. And you want to make damn sure it is not at the top end of that range.

Mr. WILLIAMS. I think progress of the type that you cited would be received extremely well by the capital markets. I agree that there is excessive focus, which means it is going to lessen, on the size of the deficit in this very year. The trend is what is important, and the trend of the size of Government spending is what is important.

Chairman DOMENICI. How about you, sir?

Mr. LEFF. Well, I do not think they would believe it in the capital markets because to get to zero the capital markets would like to see, say, the $55 to $60 billion fiscal 1981 deficit decline to, say, $40 billion in fiscal 1982. Then they would believe it. But $55 to $60 billion, then up to $75 to $100 billion in 1982, I am afraid the credibility in light of recent experience with the Government is such that I would find a very low tolerance to believe.

Chairman DOMENICI. Maybe we do not have our numbers right. What I just described would put you on a path where, under moderate economic assumptions, you would have about a $30 billion deficit in 1983 and less than that in 1984.

Mr. LEFF. What number are you using for fiscal 1982?

Chairman DOMENICI. I kind of left it out of this because I assumed that you all said that is not the most relevant one if you had this on a real path. And my hypothesis was laws were already passed changing things, yielding these savings. But I would add to it another $10 billion off the deficit in 1982 if you want, which I think is doable—$8 to $10 billion. Bringing that one from 60 to the neighborhood of $50 billion.

Mr. LEFF. All right, in that neighborhood I think you would have credibility in the capital markets.

FOCUS ON REALISTIC CUTBACK

Chairman DOMENICI. Frankly, I am delighted that you support that. I have now believed it for a month. But, obviously, to believe it and to get there are two different things. But I think it does put into perspective how you would alleviate the short-term problem without attempting to address right now whether you could balance in 1984 or not, which I think we continue to make worse until we solve the short-term problem. We are not even able to analyze whether we are plus or minus $25 billion in 1984 because we cannot project the economic assumptions. There is no way, whether we take yours that are pessimistic in 1984 or Alice Rivlin's, which are very optimistic, or Dave Stockman's and the White House, which are optimistic. We are still plus or minus $25 to $30 billion out there in 1984. If we continue to address that in the next month, it would appear to me, we will get nowhere. I mean, we will be asking for Draconian solutions. We will be asking for incredible policies that cannot be put through. I would rather focus on a realistic cutback in those years but try to get as much in place as you can now. And that is why I asked the question that way.

Do you have any questions, Senator Kasten?

WAYS TO DEMONSTRATE CREDIBILITY

Senator KASTEN. I would just like to ask this. It seems to me, especially over the last 20 or 30 minutes, that we have been talking about the lack of credibility of the monetary and the fiscal policies that we are following. In other words, somehow the market just plain does not believe that we are going to get to where we say we are going. You can look at a couple of benchmarks along the way, and you can say: see, you can't get there from here, and here's where you are now.

Except for the budget cuts that we are talking about, are there any other ways that we in the Congress can demonstrate credibility—that we do want to go toward a balanced budget and that we expect to go to a balanced budget, and that we are going to stick with the plan?

REITERATE SUPPORT FOR CONTROL OF MONETARY GROWTH

Mr. **Williams**. Well, I think you have done this, but you could do it again, and that is to reiterate support for control of monetary growth. As you said, you in a way did that with your hearings with Chairman Volcker. But, by supporting control of money, you are in an indirect way vowing that you are going to control the size of the deficit in the long run.

Senator **Kasten**. Mr. Stern?

Mr. **Stern**. I wish I had an answer. I do not have a good answer. I would simply say that the indiscrete comments some of the people that share the Senate floor with you have made have lowered credibility of whatever is said in the Senate on Wall Street. I recognize that you cannot control that at all. I think that moderating tones and trying to take the focus of the debate off Wall Street per se and move it to what you are doing in Washington would make a lot of sense and perhaps rebuild what is now somewhat of a shattered credibility.

Senator **Kasten**. You have got to understand that there are some partisan political things going on on the Senate floor as well which gums this whole thing up. Everybody wants to get there, but there are some people who have other ideas; that makes it more difficult.

Mr. **Stern**. Right.

REAFFIRMATION OF MONETARY POLICY

Mr. **Leff**. Unless you want to adopt a fascist state in the interim, I suspect you are correct that you will have two opinions.

There are only two germane components in the budget and monetary policy. We now must have a reaffirmation of tight monetary policy rather than rhetoric or polemics.

Senator **Kasten**. Thank you, Mr. Chairman. I predict that we are going to see, coming out of this committee within the next month, the rough outlines and the rough guidelines, the kinds of numbers that we are talking about this morning. I think that there is strong support. We have got difficulties in the appropriations process. We have got difficulties, but I think we are going to go in that direction. I am optimistic that that kind of a signal will be the kind of a signal that is going to start to change the trend of these interest rates and maybe help out not only my car dealers and farm implement dealers but also the homebuilders and the whole list of other people that Mr. Exon is concerned about. Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much.

Thank you very much for appearing before us. I appreciate it. The meeting is adjourned.

[Whereupon, at 12:12 p.m., the meeting was adjourned.]

Chart 1

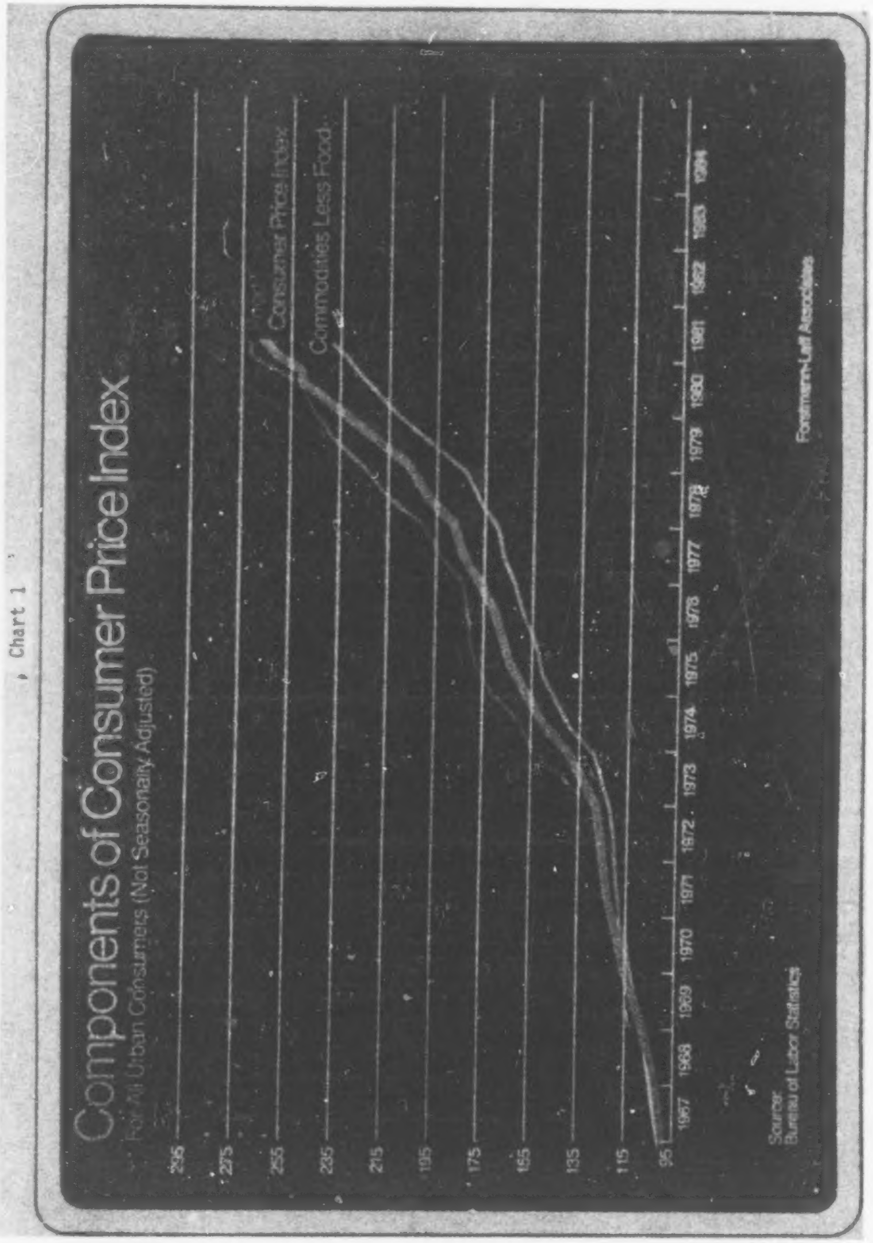

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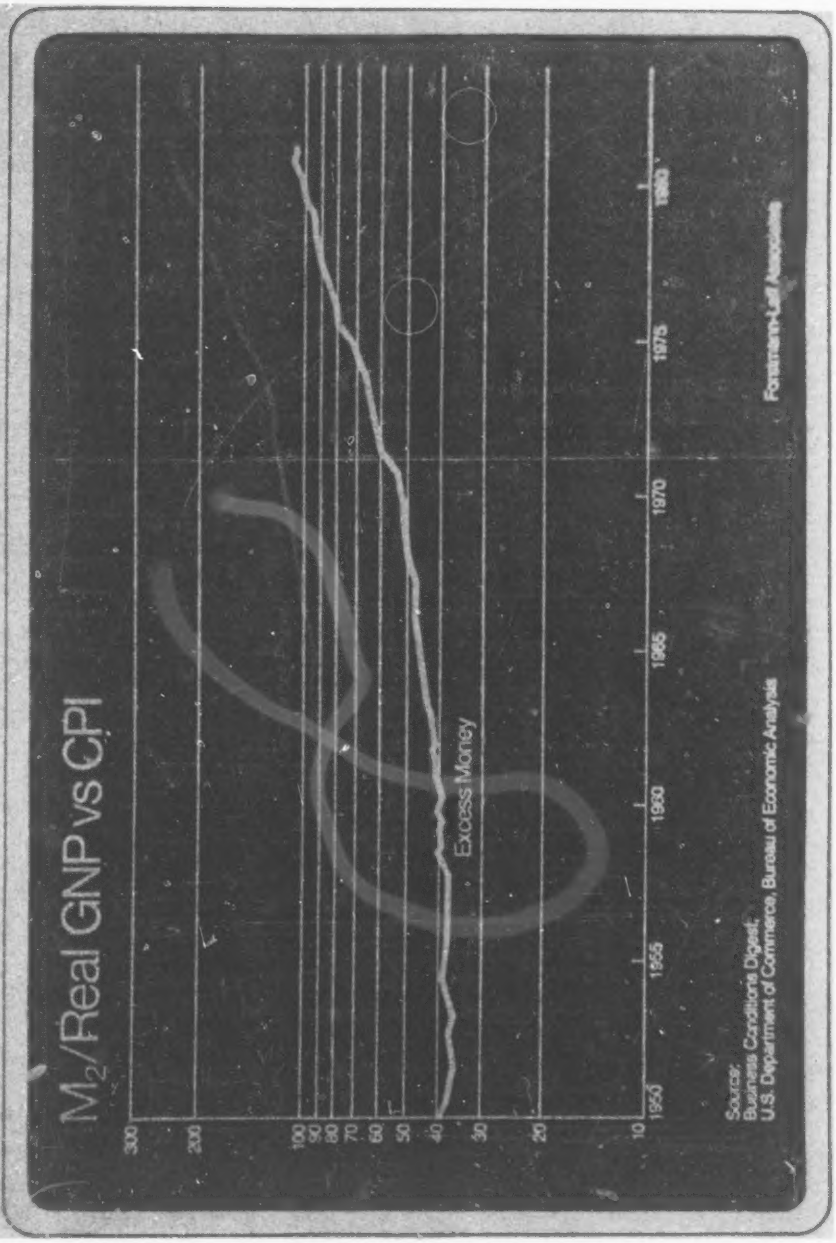
Chart 2



Source:
Business Conditions Digest,
U.S. Department of Commerce, Bureau of Economic Analysis

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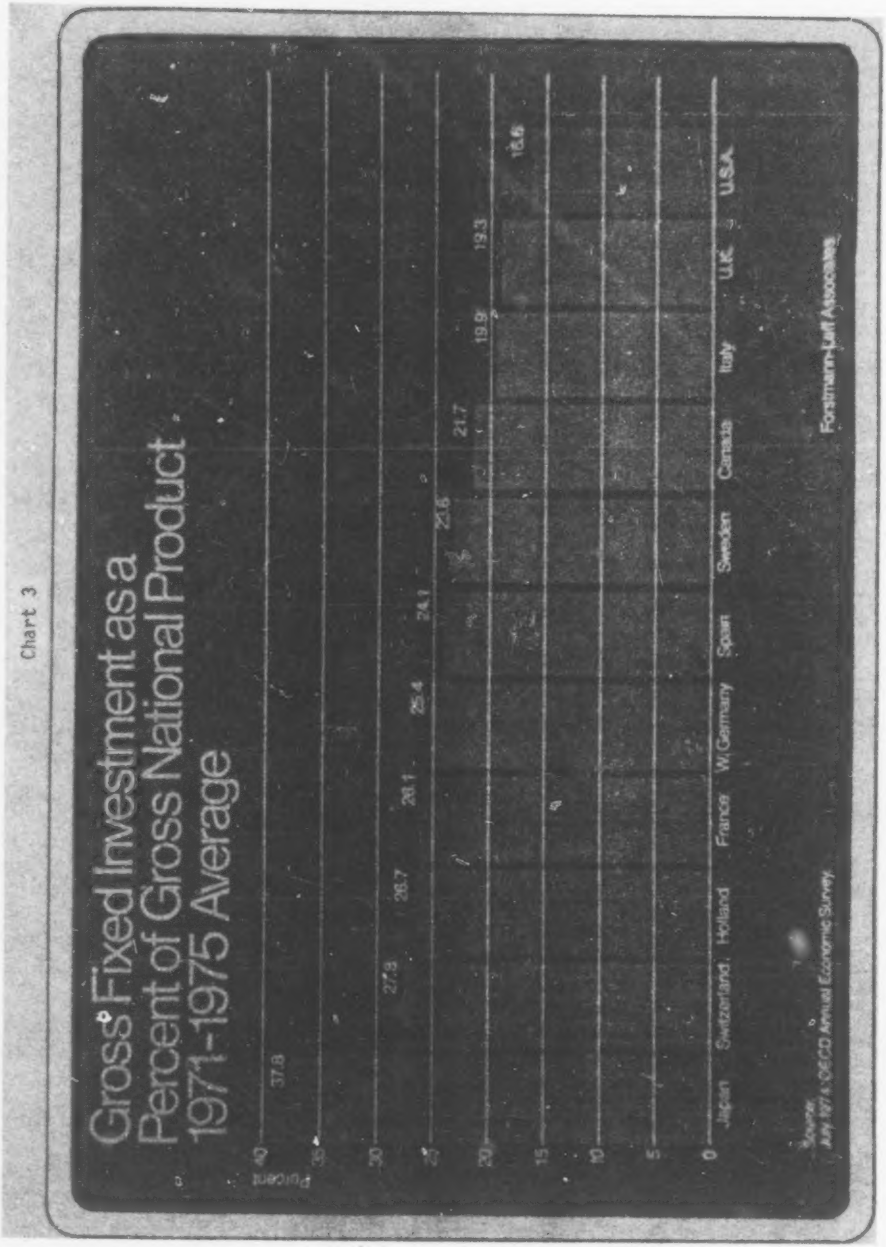
Chart 3



Gross Fixed Investment as a Percent of Gross National Product 1971-1975 Average

Source:
July 1977 & OECD Annual Economic Survey.

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Chart 4

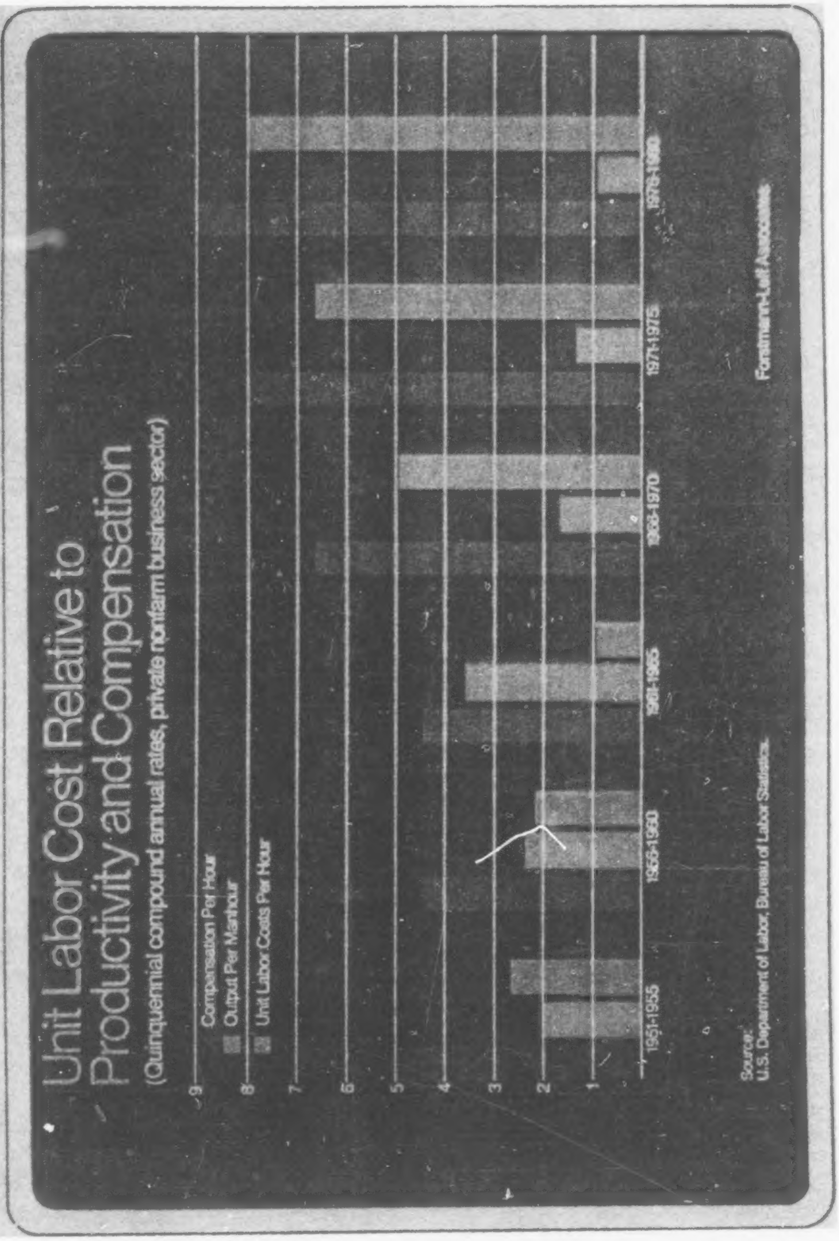

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Chart 5

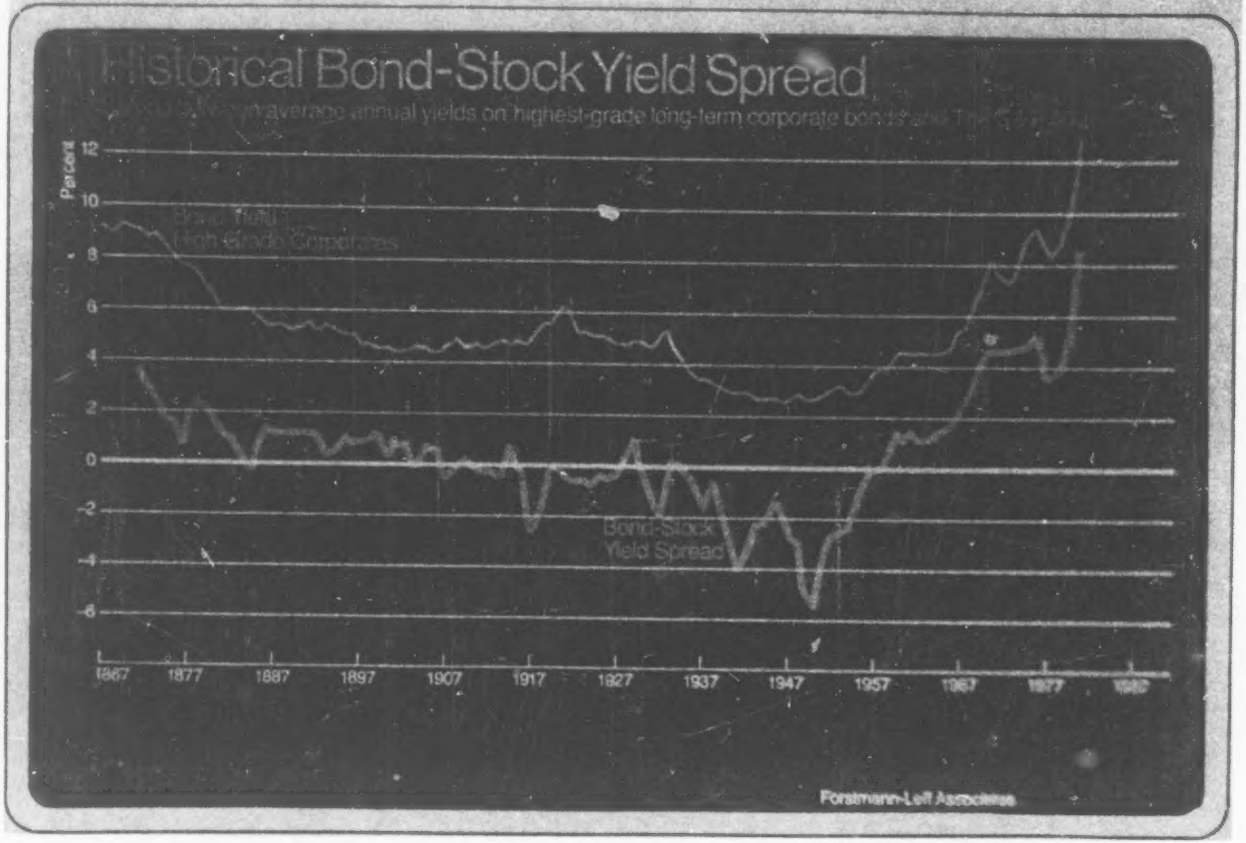

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Chart 6

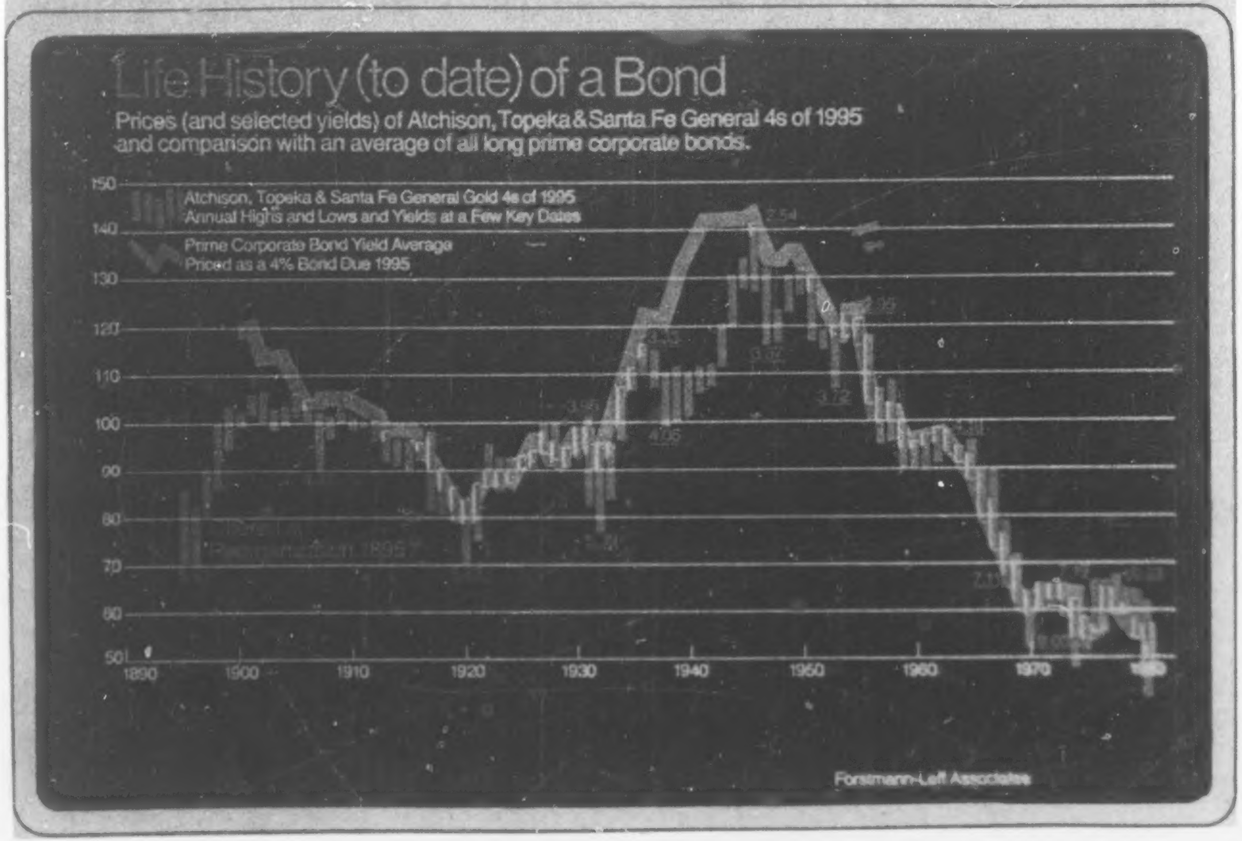

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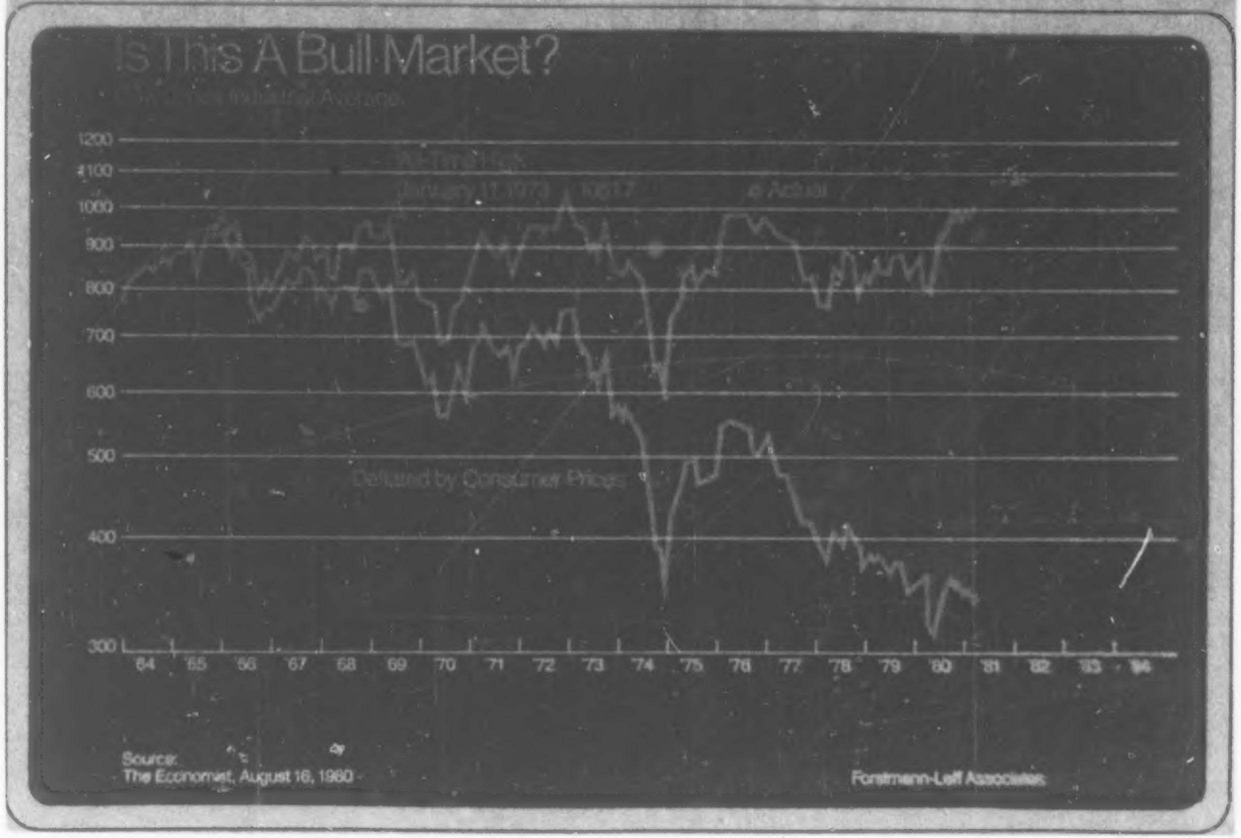
Chart 7



Source:
The Economist, August 16, 1980

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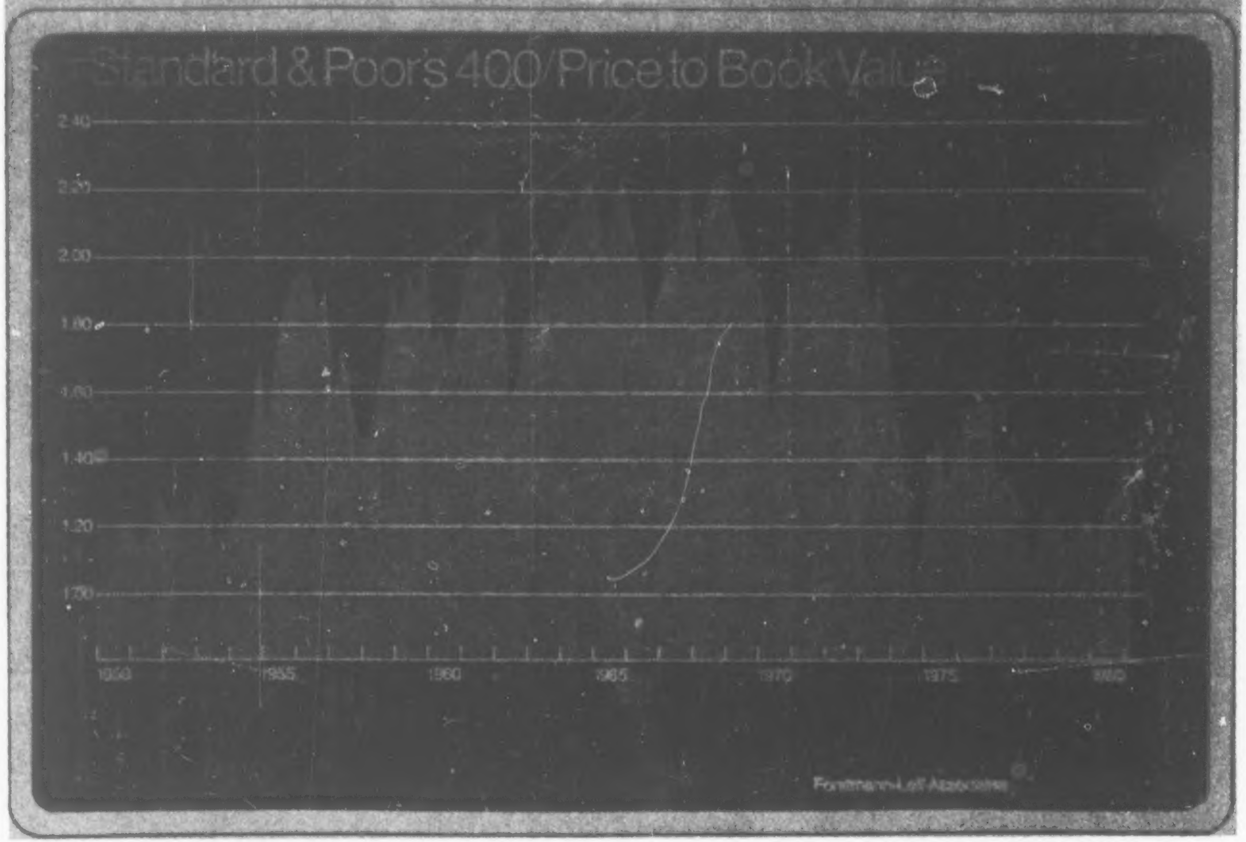
Chart 8



Standard & Poor's 400/Price to Book Value

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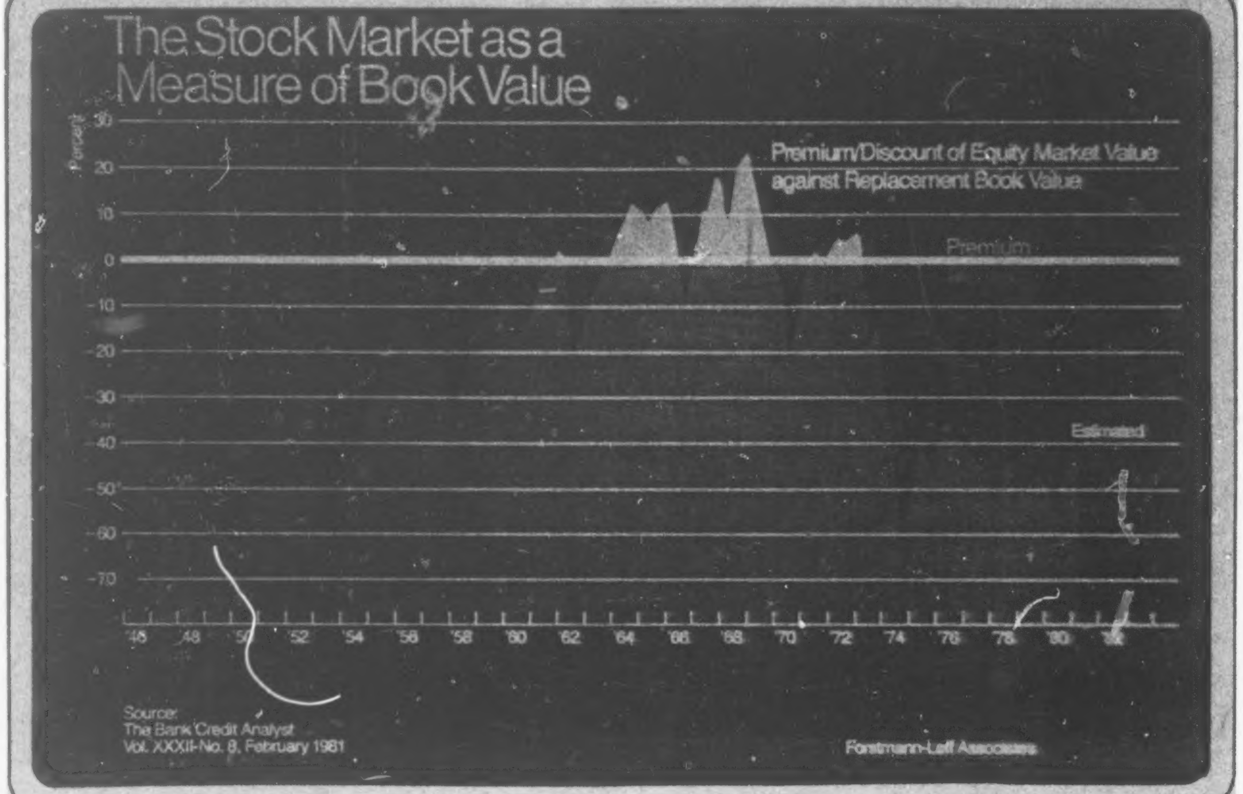
Chart 9



The Stock Market as a Measure of Book Value

Premium/Discount of Equity Market Value against Replacement Book Value

Source:
The Bank Credit Analyst
Vol. XXXII-No. 8, February 1981

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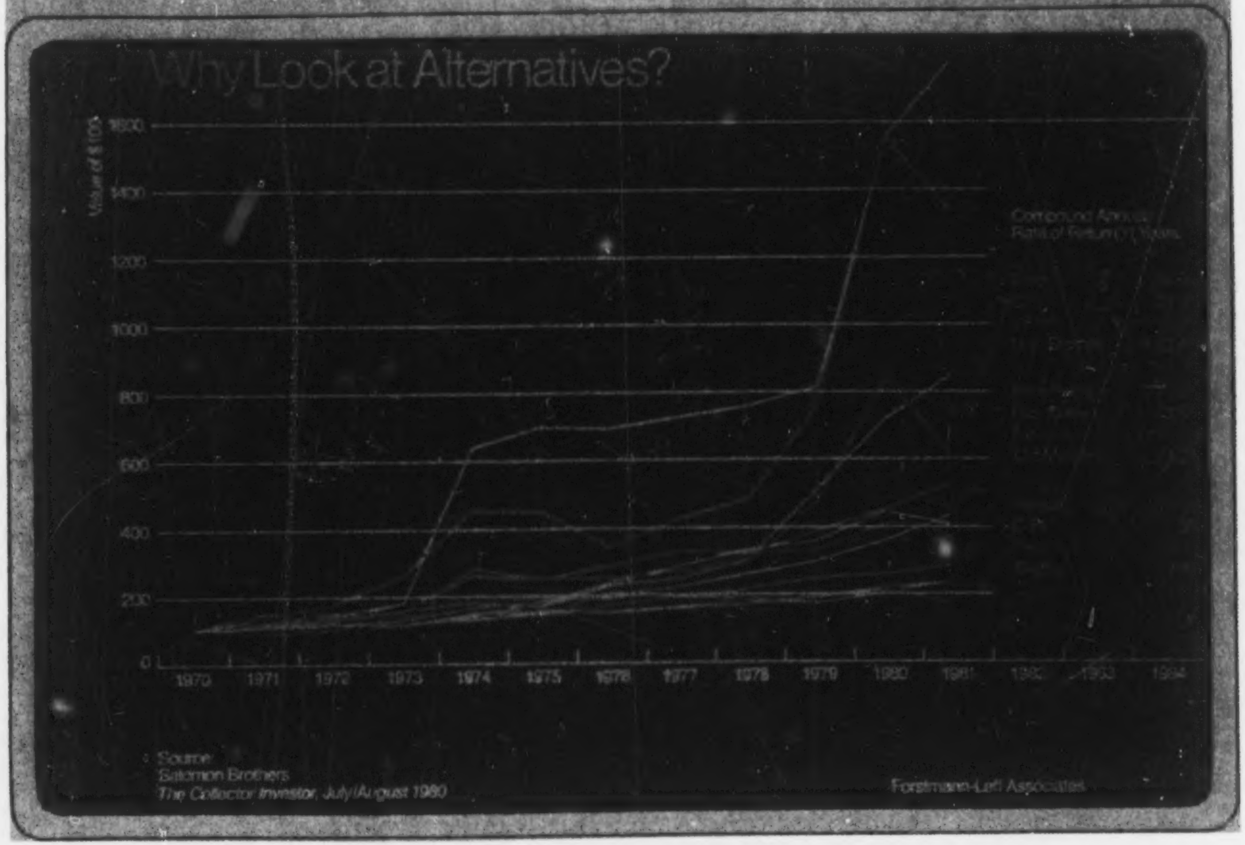
Chart 10



Source:
Salomon Brothers
The Collector Investor, July/August 1980

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VIEWS OF THE REAGAN ADMINISTRATION

TUESDAY, OCTOBER 6, 1981

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 3:25 p.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici, chairman of the committee, presiding.

Present: Senators Domenici, Symms, Grassley, Quayle, Gorton, Hollings, Biden, Johnston, Hart, Metzenbaum, Riegle, Moynihan, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The hearing will come to order.

I want to welcome Director Stockman to our committee once again. Today, Mr. Stockman will explain to the committee the administration's latest proposals for budgetary savings to reduce projected Federal deficits over the next 3 years.

I cannot emphasize too strongly, Mr. Stockman, how important these proposals are, not only for next year, which we will only be able to affect marginally, but especially for fiscal year 1983 and fiscal year 1984. Contrary to press reports, we, here in the Congress, appreciate the President's responsiveness to a deteriorating budget situation.

WALL STREET FOCUSES ON COURSE OF FISCAL POLICY

However, I am aware, as you must be, that it is not fiscal year 1982 nor is it any specific budget number that is the focus of "Wall Street" or Mainstreet, rather, it is the general course of fiscal policy over the next few years. Last week, we had before this committee three major institutional investors from Wall Street and their testimony was to the point and extremely useful. What they said simply was that the administration and the Congress were not aiding, and in fact, were endangering their credibility by holding to a deficit target of $40 to $45 billion, when, in their opinion, this was a most unlikely outcome. Rather, they felt that financial markets were looking for assurances that the Federal deficit was on the path toward balance and that the deficit this year, fiscal year 1982, would be lower than the $60 billion deficit in fiscal year 1981. In other words, in their opinion, we in the Congress should aim to control spending and the deficit and to reduce Federal borrowing requirements in a progressive and consistent manner, without respect to specific numerical targets. I must say that this is a position with which I have great sympathy.

This does not mean that we can be lax in our efforts to get the budget under control. I compliment the administration, not only for its proposals on appropriations and revenues, but especially for its commitment to long-run reductions in the entitlement programs. This is the only way that we are really going to effect enduring budgetary control.

I also appreciate the flexibility that you and the President have exhibited relative to congressional actions on the new budget proposals announced by the President on September 24. It will certainly be necessary to work out compromises on the details of these further difficult decisions that the President has called on Congress to make. However, consultation is never a substitute for leadership, and we, in the Congress, are very anxious to receive the details of the proposals that the President endorses to achieve these additional budgetary savings. I hope that Mr. Stockman will be able to provide this committee with a precise date that we can expect the President's proposals.

FURTHER BUDGET RESTRAINT IS NECESSARY

I fully share the conclusion of the President and his advisers that further budget restraint is necessary—beyond what we achieved in the recently concluded reconciliation process. We were all aware that additional actions would be required at the time this historic legislation was signed into law. I know you to be a most effective advocate of the administration's proposals to achieve this restraint, Mr. Stockman, and I look forward to your testimony.

We will proceed with the witness, 5 minutes each, including any statements you have. We will try to do that as consistently as we can. Senator Hollings?

OPENING STATEMENT OF SENATOR HOLLINGS

Senator **Hollings**. Thank you, Mr. Chairman. Perhaps I should make a few comments at the very beginning here because it is the communications bill and we are helping handle that particular bill on the floor, and it will be my amendment next up.

ADMINISTRATION RECEIVED MORE CUTS THAN ASKED FOR

I have had a chance to review your statement, Mr. Stockman. For one, you make a false assumption. I happen to have been cosponsor of the Domenici-Hollings Reconciliation or Budget Cut Act. Throughout your statement and the positions of the administration, I think we ought to have an understanding and a clear understanding at the very beginning. The assumption is that somehow we failed on the so-called first round. The President did not get the cuts that he asked for. And, having failed, now we have to begin a second round that really was come on next year's budget and next year's markup after January.

The fact of the matter is that I pursued you all year long, asking about these further cuts—they talk about your famous black notebook, but they kept it shielded, and your answer was in March and in May you would give it to us in future years, give it to us next year. In other words, you were promising a second round of cuts this year, but it was a second round of tax cuts. And the spending cuts were to come in future years.

Specifically, I know about the difference, but, when President Reagan recommended $41.1 billion in cuts, our budget review—and we pretty well agreed—looking at those things that were to be administrative actions, namely $5 to $6 billion in there was to be the Davis-Bacon, offshore drilling, and various activities of that kind. We started at the very beginning as a Budget Committee saying now the administration is asking for $33 billion in cuts. The Senate gave $38 billion but in compromise in conference we came out with $35.2 billion. So, yes, it might not be some of the exact cuts recommended, but in total amount in doing the job we gave your administration more than you asked for. And the false assumption should be cleared right away that we did not do the job.

REVENUE HEMORRHAGE DISREGARDED

Similarly, as a result of that, then you move in with a total disregard of the culprit, as we see it here, trying to mark up a second budget resolution. You totally disregard the revenue hemorrhage in those out-years that were never even contemplated by Kemp-Roth. I know they did not ask for those oil cuts. I know they were not asking for indexing. And, then when we looked around, it had gone way over any kind of mark losing some $150 billion in 1984, $199 billion in 1985, and $267 billion in 1986.

Now, having got that kind of revenue hemorrhage going of $750 billion, 15 percent of your budget on average, each year, every year, there is no way that you can stabilize the market, the economy, or lower interest rates, which is the interest of everyone, with just talking about further budget cuts and we are going to study this, and we are going to have a commission on that, and we are going to come back with further cuts, and we are going to study that, and we are going to come back with further cuts.

From your statement I find a too-casual approach with respect to the cuts themselves. For example, we think time is of the essence. We do not think we have got to 1983 or 1984. We are looking at, really, an 1984 problem in the sense of saving the economy. It has got to be saved this fall before we adjourn.

REVENUE ENHANCEMENTS

And you come along with your revenue enhancements in your statement. Incidentally, I take that that is raising taxes. You have gone to a Hollywood approach. Deficits now are potential budget gaps. There is no such thing as a deficit; it is a potential budget gap. Incidentally, there are now two kinds of potential budget gaps. I see now by the morning news you are only concerned with structural potential budget gaps and not cyclical potential budget gaps. I am trying to learn that one.

In any event, you have not lined out those revenue enhancements, or, more than anything else, you have changed your direction because you told us in March, and I quote: "I do not intend to raise taxes as a way of balancing the budget." That is your statement to this committee. Now you have got revenue enhancement or raising taxes to the tune of $3 billion, $8 billion, and $11 billion for a total of $22 billion. And then you come with entitlements reform and you look at table 7,[1] and one-third of those changes are yet to be delineated. You start your statement, saying we have got to be concrete. You also end your statement saying, we have got to be concrete.

SECOND BUDGET RESOLUTION MAY BE IMPOSSIBLE

But it is very casual. It is very loose. It is very Hollywood and totally inadequate. And that gets me to my main point. You could destroy this budget process by making it unrealistic or impossible to get this second budget resolution. When you do not come to grips with the real problem of trying to find $100 billion, which we are trying to do—you cannot give promises in the future from a political body. You and I have both been members of it for years. When you come up in your statement and say to yourself, even if you assume all the user fees and everything else are adopted in law, and the next 10 seconds you are $35 billion shy, that is totally inadequate.

When you duck the issue of revenues with respect to that hemorrhage in those out-years and then come asking us, having given big oil $12 to $15 billion, that I should come and cut military readiness? That I should come and cut stockpiles for ammunitions? Looking at the Mideast right here, and we are going to be briefed in the next half hour. That I should come and cut the school lunch further?

Your President on Monday in New Orleans spoke of the thin blue line between civilization and the jungle of crime. He finds on Friday that the blue line is not thin enough, and he thins it down by cutting 600 FBI agents, and right on down the list, the DEA budget. We had increased some of these programs in spite of going ahead with $38 billion in cuts. We provided $500 million more for the Coast Guard. We had to compromise that down to $300 million. You have emasculated that cut to $263 million. You have cut it from the Border Patrol, the IRS. So, it is not just a casual, as you have got it in the statement, percentage. We are looking at programs.

REMOVE THE SINEWS OF GOVERNMENT

What you are asking us is to take and remove the sinews of Government itself. The overwhelming Republican and Democratic majorities in this country would not want to cut the FBI and the Coast Guard and the DEA and the Border Patrol. The overwhelming majority are not going to go along with military readiness cuts or any of these other cuts right here.

So, to put it in this particular frame, totally inadequate and totally unrealistic, you are making it impossible for us to get this second budget resolution out of this committee and out of both Houses. I want you to know that in the initial stage. Your statement does not even come to grips with the problem. You dance around it. You Hollywood it. You do not even admit to what really is the culprit here. You seem to enjoy high interest rates; we don't worry about deficits, only the structural ones. And your friend, Mr. Kemp, says we do not worship at the shrine of balanced budgets. Well, as a result we got high interest rates and you are wrecking the economy.

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[1] See p. 219.

Chairman DOMENICI. Senator Hollings, I assume you have to leave soon to take care of the bill on the floor.

Senator HOLLINGS. Right. But we will need additional time. It is obvious that the distinguished Senators on both sides cannot take and handle this witness in 25 minutes.

Are we going to have to have additional time next week?

TAX CUT IS CRUEL, INHUMANE, AND GREEDY

We have got to get a budget resolution, and this is real serious work. When you see the leadership being given fountain pens. I cosponsored the resolution. I did not get that fountain pen. By God, I sat there with you, and we fought it tooth and nail right down the line. We ended up with a committee of 252 members and reconciled all of that. Now where are we? We are told we did not do the job in the second round and changed the whole thing and just stonewall the matter of revenues which they themselves never contemplated. You seem to enjoy the income transfer. We have given it all to the rich now, and you are going to be greedy about it. What Senator Metzenbaum said about cuts I say about your tax cut. It is cruel. It is inhumane. And it is downright greedy. And you keep grasping at it and ignoring it and blaming the Congress. And now you are starting, more or less, a political in-fight that will continue on with high interest rates while the country goes broke. That is the wrong kind of leadership. We will never get a second resolution with these kinds of things in here finessed as revenue enhancements and potential budget gaps and that kind of nonsense. Thank you, Mr. Chairman.

Chairman DOMENICI. We have Senator Grassley's prepared statement that we will insert into the record at this point.

PREPARED STATEMENT OF SENATOR GRASSLEY

Mr. Chairman, I am very pleased that we have OMB Director Stockman here to testify before our committee. I have long awaited the opportunity to discuss a few details pertaining to the Second Budget Resolution with him, and am pleased that we now have that chance.

As we all know, we have worked many months to set the budgetary elements of the Economic plan into place. None of it has been easy but due to the effort of this committee, our distinguished Chairman, and the Administration, we have been successful in bringing about changes that will lead to renewed economic growth and productivity that this country needs. As a member of both the Budget and Finance committees, the Reagan anti-inflation plan has been my top priority, and though we have seen preliminary signs of its success—such as the decline in inflation to less than 10 percent—I look forward to seeing further signs of economic recovery.

Mr. Stockman, in your testimony, you mention that the fundamental challenge remaining is to continue the momentum that we have had for the past eight months. We must view our achievements as a base of economic reform from which we must build and expand. I agree wholeheartedly with you on this. Not only must we expand upon the changes we have made, but we must approach this as a partnership between both the Administration and Congress. The President has, as you have discussed, recently recommended further proposals for additional savings. It is now up to Congress to dispose of these suggestions as we see fit. I propose that we take this task as seriously as we did reconciliation. In instances where we do not demonstrate full appreciation for the President's ideas, we should propose our own.

We should even seriously consider reducing spending more than the President has recommended.

More than a few of my colleagues are abandoning the goal of a balanced budget by 1984. Some would even insist that you take this line, too, Mr. Stockman. I am much relieved to hear that you have not. On page 21 of your testimony, you show that there are $343 billion worth of options for cuts in 1984 that would not endanger our national security, default on the national debt, or cut social security. I hope that as we approach the Second Budget resolution for fiscal year 1982 you will work with this committee to find all the reasonable options for bringing our federal spending under control. This Administration has my full support for its new fiscal initiatives, as well as the long-term goal of economic recovery.

Chairman DOMENICI. Mr. Stockman, you have a prepared statement. You can deliver it or make it a part of the record. Proceed as you desire.

STATEMENT OF DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Mr. Chairman, thank you very much. I have a prepared statement, but I think I would like to dispense with that and have it included in part of the record[1] and then proceed to the answers——

Senator METZENBAUM. Mr. Stockman, may I interrupt you for 1 second? I wanted to ask the chairman a question.

Is it the intent of the chairman to adjourn or recess slightly before 4 o'clock so that all of us may go to the briefing?

Chairman DOMENICI. Well, it has been changed to 5 o'clock.

Senator METZENBAUM. It changed to 5 o'clock; I apologize. Is it your intention then at that point to do so?

Chairman DOMENICI. Let me say to the distinguished Senator from Ohio I do not have any intention formed yet with reference to that. If you will bear with me and see how we are going, I will decide what most of the Senators want to do. I certainly do not intend to deny anyone an opportunity to inquire and make their statement. If we want to recess, we will have to arrange with Mr. Stockman for additional appearances, or we would have to wait around until after the briefing and come back.

I might ask this of Mr. Stockman. We are doing our best and so are you to get your evidence before this committee. If we were to recess for a while at 5 o'clock, how late can you be here if we need to try to finish this evening?

Mr. STOCKMAN. Mr. Chairman, I can stay as late as the committee wants to be in session.

Chairman DOMENICI. All right. Then proceed.

Mr. STOCKMAN. Mr. Chairman, I had indicated that I have a prepared statement in which I try to analyze the current budgetary condition and outlook and the set of initiatives that we have proposed, but I would like to dispense with that entirely and begin the round of questioning. Before I do that, I do want to respond to the solo dissent on the tax bill that Senator Hollings has so eloquently delivered. I do note that this was not a problem caused by me or a problem, if it is defined that way, caused by the President. There was one member of this committee, the Senate Budget Committee, that voted against the tax bill.

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[1] See p. 203.

TAILOR SPENDING SUIT TO FIT REVENUE CLOTH

We have decided that that is sound policy for this country. It seems to me that what we have to do now is sit down and determine how we tailor the spending suit of this Government over the next several years to fit the revenue cloth that we have available.

Let me say from the outset that I do not accept the metaphor—and, surely, that is all it is, perhaps not a Hollywood metaphor, maybe some other kind of metaphor—that we have a revenue hemorrhage in store over the next 4 years, or that we have starved the Government of the income that it needs to do essential things.

I would point out to Senator Hollings and other members of the committee, that had we not changed the tax law of this country with a view to stimulating business investment, with a view to cutting marginal rates and restoring personal incentives, revenues would have increased over the next 5 years at a 13-percent rate, well in excess of the expected GNP growth rate over that period. Tax burdens as a share of GNP and personal and business income would have continued to climb from the historic levels of today to totally unprecedented levels of 23 or 24 percent of GNP.

$4 TRILLION ENOUGH TO MAINTAIN SINEWS OF GOVERNMENT

The fact is that prior to the Tax Act last summer, the Federal Government would have collected, over the next 5 years, $4.6 trillion worth of revenue. We have now decided that $720 billion of that need not be collected, that it should be left with the business enterprises and individual producers in our society on whom we depend to make our economic system work. We will have $3.9 trillion left, even with this great revenue hemorrhage of which the Senator speaks.

It seems to me that working together to establish priorities, and discriminating between what is necessary or not necessary both in defense and nondefense, that we can find some way to make ends meet on nearly $4 trillion over the next 5 years to fund defense, to fund social security, and to meet other important national objectives.

I cannot believe for the life of me that $4 trillion over 5 years is not enough to feed and maintain the sinews of Government of which the Senator has spoken.

REASONS FOR ADDITIONAL BUDGET REDUCTIONS

Now, why have we proposed these additional budget reductions that were always implicitly part of the plan for 1983 and 1984? Why have we proposed that the Congress start now? Primarily because the momentum of past policy decisions and past spending. The size of the national debt that we carry and must finance is impinging so heavily on our budget targets, both this year and next year, that we would be better advised to start now. This is necessary not only to contain the threats to the 1982 budget but to get underway and in motion those policy changes, in entitlements and discretionary programs, and those other changes that will have to be made in order to close this gap—deficit, if that is the term that is preferred—in the 1983 and 1984 period.

I would not suggest that the fact that the budget is closing in upon us with so much momentum is the fault of this committee, or this Congress, or the action taken last summer. We simply confront an empirical fact of life. These circumstances that are not our doing, but are inherited and are a common problem for all of us.

The first budget resolution for 1982 called for an outlay level of $695 billion. Our estimate of base outlays right now is $722 billion. If we were to fund all of the authorization ceilings in the discretionary programs contained in the summer reconciliation bill, the outlay level would reach $726 billion. That would be more than a $30 billion overrun from the first budget resolution and from the target of this administration. It would result in a $63 billion on-budget deficit. Including off-budget, the deficit would be over $80 billion.

That is not anybody's fault. Part of it is due to higher debt service cost. Part of it is due to the fact that we have had a collapse of wheat, corn, and other commodity prices and have therefore gotten $2.4 billion in additional expenditures that nobody could anticipate.

Part of it is due to the fact that entitlement programs, even after their reform, continue to have forward momentum in terms of caseloads, benefit levels, and cost. Medicare will cost $800 million more than any of us including the Budget Committee staffs and CBO, thought a few months ago.

We are finding, as we implement many of these entitlement reforms that were enacted by the Congress in reconciliation, that the first-year savings will not fully materialize because we have lags and delays in implementation. It will take the States time to change their AFDC rules. It will take them time to implement those changes at the field level, just to use one example.

OUTLAY LEVEL AND DEFICIT SOARING OUT OF CONTROL

So, my first point is let us not look to the past. Let us not look to who is to blame. Let us face and respond to reality. And that is that the outlay level and the deficit are soaring again this year, for the third year, out of control. In my judgment, there is no way that we can get interest rates down and restore financial confidence in the markets of this country if we have another $80 billion borrowing year, the third year in a row, and if we permit the budget again to soar out beyond our targets.

ENORMOUS LAGS BUILT INTO SYSTEM

The second reason why I think that we need to start this fall, not only on these measures to stem the tide in 1982, but to begin to carve out the savings, and the additional revenues that will be needed in the out-years, is simply the discovery that I think all of us made as we went through the reconciliation and tax process this summer. And that is that there are enormous lags built into this system. If we wait until 1983, much of the outlay savings that we need will be impossible to achieve because it will require drastic reductions in budget authority or drastic and quick changes in entitlements that simply are not realistic or feasible to do make. The same is true for 1984.

STRUCTURAL PROBLEM

I would suggest that there is good reason to address what I would call the structural problem. That is finding a way to fit the budget or the outlay side with the tax program that we have adopted and do it on a 3-year basis to close that remaining gap that was left after reconciliation.

If the impression has been given that I have somehow denigrated or have underestimated or underappreciated the work of Congress in the reconciliation bill, the unprecedented and historic bill that we passed, let me clarify that. In my statement I indicate that half of the job that needed to be done to bring a budget that was soaring at a 14- or 15-percent growth rate back into conformance with a tax system and a tax level that is compatible with economic growth, was done in the reconciliation bill last summer. In table 3 [1] I think we have indicated this very clearly. You have cut the growth rate of Government spending over the next 3 years from nearly 10 percent to a little over 7.5 percent. That is over half of the savings needed, approximately $130 billion out of $247 billion that will be needed over that period.

CUTS COULD COME FROM $350 BILLION SPENDING BASE

I cannot believe that the remainder of the job is impossible to do. There has been an argument made by some in recent days and weeks that, after you set aside national defense, which we believe cannot be cut any more than this adjustment that the President has announced, and after you set aside social security, which should not and will not be cut for budgetary purposes, and the mandatory interest on the debt, there is not much left in the budget. the argument has been made that the base of programs available for trimming, for consolidaiton, for elimination, or for cutback simply is not there.

In my testimony I have tried to demonstrate that that simply is an erroneous and fallacious notion. In 1984 I believe we are looking for somewhere in the range of $42 billion in cuts, outlay cuts outside of the defense savings and the revenue measures that we have proposed. Those could come out of a base of $343 billion in spending for items or programs other than defense, social security, and interest. You are talking about a part of the Government other than those three big-ticket items that could be considered for a 12-percent reduction, maybe not in every program, but a 12-percent reduction in the aggregate.

I do not think that this is totally beyond the range of realism. I do not think it is totally beyond the range of feasibility. Nor is it totally beyond the range of desirability in terms of meeting important national objectives. The question upon which this committee will have to deliberate is whether or not it can be done, whether you want to do it, or whether you have some other alternative.

I will conclude by saying that the President has invited a dialog. We have one configuration of how, through defense savings, revenue enhancements, discretionary program cuts, and entitlement reforms, we can close that gap. There undoubtedly will be other ideas, other mixes. That is what this process is all about. I welcome the chance to meet with you and discuss the options.

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[1] See p. 214.

Chairman DOMENICI. Without objection, we will insert your statement.

EXECUTIVE OFFICE OF THE PRESIDENT
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STATEMENT OF DAVID A. STOCKMAN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you to discuss the economic and budget outlook, as well as the Administration's new fiscal initiatives.

Two weeks ago, when he addressed the Nation, the President underscored his determination to carry forward with his overall economic program to break the inflationary pessimism that now grips the Nation's capital markets and to revive investment, job creation and economic growth. The fundamental challenge now is to build upon and extend the key parts of the President's program that have been enacted this past spring and summer.

In Congress:

- A major step toward effective Federal spending control was taken with the passage of the Budget Reconciliation Act — saving $130 billion over three years;
- Passage of the incentive-oriented tax program has enhanced prospects for a revival of saving and productive investment.

Outside of Congress:

- The effort toward deregulation has reduced the pages of the Federal Register by one-third, new rules have been cut in half, and modifications or revisions will save billions of dollars for consumers;
- The Federal Reserve continues its part in the fight against inflation by making further progress toward the goal of reducing the rate of growth of the Nation's money supply.

Current Situation

At the risk of sounding a contrary note amidst the current fashion of gloom and doom, the impact of the President's program already has achieved some notable successes, particularly on the core problems of inflation and inflation expectations. Last winter the Administration's forecast of declining inflation was dismissed as overly optimistic, yet the first 8 months of 1981 have witnessed considerable progress on the price front when compared to the performance over the same interval of the previous year.

During the first eight months, every measure of inflation has declined substantially:

Decelerating Inflation
(% change, annual rate)

	CPI	PPI	GNP Deflator	
first 8 mos. 1980	12.0	14.8	1979:4 to 1980:2	9.5
first 8 mos. 1981	9.6	8.3	1980:4 to 1981:2	8.0
reduction:	-2.4	-6.5		-1.5

The rate of increase in the consumer price index is 20% lower than a year ago. The corresponding numbers for the producer price index and the GNP deflator are 44% and 18%, respectively.

More importantly, the inflationary commodity speculation of 1978-1980 has been halted, and 1981 has witnessed a sustained decline of commodity prices in general and gold and silver prices in particular. During the period of excessive government spending and credit expansion in the late 1970's, inflationary expectations flourished and the purchasing power of money declined at a record rate. As a result, world markets experienced an unprecedented flight of capital out of financial assets and into tangible assets of all sorts. Gold, silver, commodities, Persian rugs and other collectibles became the star investment performers, while productive investment and capital formation stagnated.

Investment flows in 1981, however, have reversed the 1978-80 pattern, and the prices of gold, silver and other tangibles have fallen substantially. The Administration's economic program, with its emphasis on fiscal restraint, investment incentives and sound money, appears to have fostered an unwinding of inflation expectations. Although investors are as yet unwilling to undertake long-term commitments, there has clearly been a shift in investment preferences in 1981 from non-productive tangible assets into short-dated financial securities.

This movement from real assets to money assets is shown in Table 1.

Table 1 -- PRICE RANGES
January through August
1979-81

		GOLD ($/oz)	SILVER ($/oz)	TRADE WEIGHTED DOLLAR (1973=100)
1979				
	High	300.82 (Aug)	9.28 (Aug)	90.3 (May)
	Low	227.27 (Jan)	6.25 (Jan)	86.9 (Jul)
	Last	300.82 (Aug)	9.28 (Aug)	87.2 (Aug)
1980				
	High	675.31 (Jan)	38.26 (Jan)	91.1 (Apr)
	Low	513.82 (May)	12.53 (May)	84.7 (Jul)
	Last	627.15 (Aug)	15.90 (Aug)	86.1 (Aug)
1981				
	High	557.39 (Jan)	14.79 (Jan)	112.3*(Aug)
	Low	409.06 (Jul)	8.62 (Jul)	91.4 (Jan)
	Last	410.12 (Aug)	8.93 (Aug)	112.3*(Aug)

*Highest since 1972

Gold has declined 40% from its 1980 high; silver has fallen 77% from its 1980 peak; and the trade-weighted exchange rate of the dollar is 33% above its low point registered in July of 1980. These measures are all evidence that the dis-inflationary process is underway.

But the crucial issue before us is whether these first steps toward financial and economic recovery can be permanently sustained during the years ahead. Right now the capital markets are flashing a signal of low confidence. Interest rates beyond two-year maturities stand at record and near-record highs. Investment activity is at low ebb and the economy is stalled.

Despite some initial policy successes, there is widespread skepticism and doubt over the resolve of the government to continue on the course necessary to achieve the President's ambitious fiscal objectives. The Administration has inherited an oppressive legacy of fiscal mismanagement and broken promises. This legacy, in turn, has generated a pervasive attitude of pessimism regarding expectations of future government spending and borrowing, future money growth and future inflation. Interest rates have become the economic metaphor of our time, and the continuous rise of most interest rates is a pessimistic expression that a better, non-inflationary future is not yet assured.

Sources of Financial Market Concern

The fears of the marketplace are well founded. During the past 15 years budgetary discipline has eroded and the government's fiscal position has shifted deeper and deeper into the red. Deficits, once thought to be a stabilization tool during periods of slack, have become permanent fixtures regardless of the economy's position in the business cycle.

The table below shows the correlation between rising deficit levels and the sustained deterioration of both price and output measures.

Deficits, Inflation and Economic Performance

	Level of the NIA Federal Deficit ($ b)	GNP Deflator	Output Per Hour*	Unempl Rate
1960-65	1.3	1.6	3.4	5.5
1966-70	5.0	4.2	1.9	3.9
1971-76	29.7	6.3	2.1	6.4
1976-80	40.9	7.2	0.9	6.7

*Private business sector.

Today's financial market crisis results principally from an ever-worsening imbalance between the supply and demand for capital. The principal source of this crisis is the massive fiscal overhang of all forms of Federal and federally-assisted borrowing, and the collision of this expanding Federal credit demand with a shrinking growth rate of private savings and capital.

Most analysts have focused on the steady rise of Federal deficits during the 1970's and the early 1980's. But this is only part of the story. Apart from the traditional borrowing to cover on- and off-budget commitments, in recent years a new surge of Federal credit demand has resulted from the proliferation of off-budget loan guarantees as well as direct lending by government-sponsored enterprises.

Direct borrowing by the Treasury in 1980 amounted to $70.5 billion (on- and off-budget), but guaranteed loans and government sponsored enterprise borrowing raised the overall credit demand under Federal auspices by another $53.8 billion, for a total of $124.4 billion of Federal borrowing. This borrowing absorbed 36% of all funds raised by the non-financial sector in 1980. In fiscal year 1981 the Federal absorption rate is estimated to rise to 43%. If the tax-exemption privilege is figured into the calculation, then the absorption rate of all funds raised for Federal and federally-assisted uses comes to 41% in 1980 and an estimated 50% in 1981.

The explosion of government and government-assisted credit has dwarfed the much discussed rise in deficits and has disrupted nearly all forms of economic and financial activity. Inflation expectations have intensified and interest rates have come under constant pressure. The disruption of financial markets has interfered with the conduct of monetary policy. The flow of private savings and capital has been preempted from the most efficient market directed uses. This government absorption of real resources has inhibited the growth of investment, real output and jobs. Market risk has been distorted and credit standards have been eroded. Inflationary pressures have been exacerbated.

The table below shows the direct relationship between the rise of Federal credit demand, the absorption rate, and the trend in both short- and long-term debt issues.

	Average Federal and Federally-Assisted Borrowing			
	Volume ($b)	Absorption Rate (%)	3-mo T bill (%)	20-yr T bond (%)
1955-1969	9.8	16.6	3.5	4.2
1970-1979	58.1	24.9	6.3	7.5
1980	124.4	35.5	11.4	11.4
1981	154.5 (e)	43.0 (e)	14.8 (thru Aug)	13.4 (thru Aug)

To reverse these deeply ingrained expectations of rising government borrowing, escalating interest rates, accelerating inflation, and the pervasive attitude of skepticism, additional concrete budget policy actions must be taken immediately.

Congressional actions to date have been important first steps — but only first steps. Additional budget measures are essential. We cannot wait because the national skepticism will not wait. The financial market situation requires immediate relief from burdensome Federal borrowing.

Lessons of Past Budget Trends

In some part, current financial markets reflect a deeply embedded skepticism engendered by the severe fiscal excesses of the recent past. From 1978 to 1981 Federal outlays increased from $451 billion to $662 billion — an annual average rate of 13.7%. In 1980, the growth rate was nearly 18 percent. Meanwhile, Federal spending increased from 21.6% of GNP to 23.1%. Such growth was clearly excessive and unsustainable without huge deficits, steady tax increases, or both.

Moreover, in 1980 and 1981 there were major overruns in outlays from original spending targets. These overruns were a major cause of the deep skepticism I just mentioned. In 1980, outlays were $580 billion, $48 billion more than originally planned in the First Concurrent Resolution for that year. In 1981, the corresponding overrun appears likely to be of the same magnitude, increasing from the original target of $614 billion to an estimated $662 billion.

There is an increasing danger of a repeat of major overruns in 1982 with the same consequences: high interest rates, low economic growth, and instability in the financial markets.

Our September estimate of 1982 outlays, reflecting cuts from the Reconciliation Act, show outlays of $722 billion, an upward revision of $27 billion from the First Concurrent Resolution passed only 5 months ago, and $17.5 billion above our July Mid-Session Review estimates. If allowed to occur, this would raise the rate of growth in 1982 outlays to 9.1%. If appropriations are enacted at the levels authorized in the Reconciliation act, estimated 1982 outlays will increase by a further $3.5 billion, to $726 billion. This would represent an increase in outlays of $64 billion, or almost 10% over the 1981 level. Taking into account off-budget transactions, Treasury would have to borrow about $80 billion. Again, revival of financial market confidence and the re-establishment of fiscal policy credibility will be seriously retarded if this familiar overrun pattern is permitted to occur for yet another budget cycle.

Table 2 — Revisions to 1982 Outlays:
Mid-Session Review to September
(in billions of dollars)

Major policy changes:	
Deletion of social security proposals	3.8
Effect of Reconciliation Act on entitlements and uncontrollables	2.8
Subtotal: policy	6.6
Reestimates:	
Interest on the public debt	5.6
Farm price supports	2.4
Medicare	.8
Food stamps	.7
Conrail	.2
Immigration package	.1
Peacekeeping (Sinai)	.1
Other (net)	.9
Subtotal: reestimates	10.9
Total	17.5

To be sure, these expansionary spending pressures would have been far greater in the absence of the unprecedented budget restraint enacted in the Reconciliation Bill. Estimated budget outlays in 1982-84 — before taking into account the Administration's spending restraints — were projected (conservatively) to be increasing at about a 10% annual rate, as shown in Table 3. The Omnibus Reconciliation Act of 1981 produced reductions in Federal spending unprecedented since the end of World War II — reductions that will reduce Federal spending by more than $130 billion over the 1982-84 period. The annual growth rate in outlays will drop by more than 2 percentage points during this period. The Reconciliation Bill achieved over half of the total savings needed to reach a balanced budget in FY 84. This was an important and essential first step in achieving restraint in Federal spending.

Table 3. — Budget Outlays: 1981-84
(dollar amounts in billions)

	1981	1982	1983	1984	Average Annual Growth Rates 1981-1984
Baseline outlays prior to restraint	662.3	761.0	818.5	875.6	9.8%
Effect of Reconciliation Act	0.1	-35.2	-44.0	-51.4	
Post-reconciliation outlays	662.4	725.8	774.5	824.2	7.6%
Target outlays*	662.4	709.3	737.0	771.0	5.2%
MEMORANDUM					
Initial size of budget problem in 1982-84 (baseline minus target outlays)	n.a.	51.7	81.5	104.6	
Savings achieved through reconciliation in 1982-84	n.a.	35.2	44.0	51.4	
Percent of needed savings already achieved	n.a.	68%	54%	49%	

* To achieve FY 84 balanced budget

However, we must now face the reality that this first important step is only a good beginning. Further timely and decisive actions to achieve the 1982 spending target set by the President and to move us toward the balanced budget in 1984 are now essential.

Viewed from the perspective of the Administration's budget plan, there are serious threats to achieving the 1982 budget target and the 1984 balanced budget goal. As Table 4 shows, the lower-than-proposed spending cuts of entitlements in the Reconciliation Act add an estimated $13.6 billion to spending over the 1982-84 period. Inaction on social security adds another $19.6 billion. Appropriations enacted at the full levels authorized, would add an additional $14.4 billion. In total, these threats could add almost $48 billion to 1982-84 spending.

Table 4. — Potential Add-ons to President's Budget Plan
(in billions of dollars)

	1982	1983	1984	Cumulative 1982-1984
Effect of Reconciliation Act on entitlements and uncontrollables	2.8	4.3	6.5	13.6
Inaction on social security proposals	3.8	6.2	9.6	19.6
Mandatory increases	6.6	10.5	16.1	33.2
Effect of enacting appropriations at authorized levels 1/	3.5	5.5	5.4	14.4
Total potential add-ons	10.1	16.0	21.5	47.6

1/ The September baseline estimates do not include these potential add-ons to outlays because they have not yet been reflected in action on appropriations.

The current budget outlook — in the absence of further policy actions — is for budget deficits of about $60 billion in each of the years 1982-84, as shown in Table 5. Such deficits are consistent with the outmoded policies that have plagued our economy for too many years. Unless corrected, the economic results are predictable: high interest rates, continued financial disorder, lagging investment and output growth, and the threat of renewed inflationary momentum.

Table 5. — Comparison of Mid-Session Review and Current Policy Baseline (in billions of dollars)

	1982	1983	1984
Outlays			
July Mid-Session Review	704.8	728.7	758.5
Policy differences and reestimates	17.5	10.5	16.1
Unidentified savings assumed in July	—	29.8	44.2
September baseline estimate ..	722.3	769.0	818.8
Receipts:			
July Mid-Session Review	662.4	705.8	759.0
Effect of tax bill and other changes	0.8	0.3	1.0
September baseline estimate ..	663.2	706.1	760.0
Potential budget deficit (-)	-59.1	-62.9	-58.8

Spending Lags

The potential size and seriousness of the emerging budget gap require rapid and urgent action. As members of this Committee you know that a large portion of the budget cannot be changed quickly. Twenty years of spending momentum cannot be reversed in twenty weeks. The lags between policy changes and budget outlay effects underscore the high costs of delay. For example:

- The first-year impact of community development block grants is only 2% of the amount obligated.

- Most of the appropriations for Corps of Engineer construction projects are for the annual incremental costs of ongoing projects. Therefore, substantial cuts in appropriations imply not only no new starts, but the suspension of ongoing construction.

- Outlays for waste treatment plant construction will be $3.8 billion in 1982. A significant portion of those outlays will be for projects approved as long ago as 1978.

- Ten to twelve percent of funds for foreign economic assistance projects are disbursed in the first year, and only 25% to 30% more in the second.

— Many defense programs have even longer lags. For the defense budget as a whole, excluding direct payroll costs, between 30% and 40% of outlays occur in the year after the year for which the funds were originally appropriated.

In addition to the problem of lags between budget authority and outlays, there is also a serious tendency for the effect of important legislative reforms to become eroded. For example, the Administration proposed $6.5 billion of reductions to the 1982 budget for AFDC, medicaid, food stamps, guaranteed student loans, and child nutrition programs combined. This proposal reduced these programs from $45 billion under current law to $39 billion. However, during action on the Reconciliation Bill the savings were reduced by $2.2 billion. Reestimates in July further eroded the savings by $1.6 billion. Delays in regulations and other measures necessary to achieve the savings, as well as unanticipated increases in caseload, threaten to erode the savings by another $2 billion. If this happens, 1982 outlays for these programs will end up virtually where they began in March under current law.

Table 6
Entitlement Slippage
1982 Outlays for AFDC, Medicaid, Food Stamps,
Guaranteed Student Loans, and Child Nutrition
(in billions of dollars)

March current law total	45.3
Savings proposed by the Administration	-6.5
Reconciliation policy slippage	2.2
Additional slippage for reestimates	1.6
September total	42.7
Further potential reestimates	2.1
Potential total	44.8

The Fall Budget Program

On September 24 President Reagan reported to the nation on progress to date in securing adoption of his program for economic recovery, and announced new measures to ensure that we stay on track toward steadily declining deficits and a balanced budget by 1984. The new measures he outlined reflect his continuing commitment to reduction of the size, cost, and burden of government, and to reducing Federal and federally-assisted borrowing demand, which is contributing to high interest rates.

Table 7.—Proposals for Closing the Budget Gap
(fiscal years; in billions of dollars)

	1982	1983	1984
Potential budget gap	-59.1	-62.9	-58.8
Budget improvement measures:			
Defense slow down	2.0	5.0	6.0
Revenue enhancement	3.0	8.0	11.0
Entitlements reform	2.6	10.0	15.0
12% across-the-board FY 1982 cut	8.4	5.3	3.8
Subtotal	16.0	28.3	35.8
Savings to be proposed in FY 1983-84	—	11.7	23.0
Target deficit	-43.1	-22.9	—

The program involves reductions in 1982 appropriation requests for both defense and nondefense programs of $26 billion, and allocation to departments and agencies of specific budget outlay ceilings to ensure that previously unspecified budget savings for 1983 and 1984 will be attained.

Federal loan guarantee activity will be reduced by approximately $20 billion. The planned reductions will ease the pressure on credit markets, and on interest rates. Also, efforts to collect outstanding debt owed the Federal government will be stepped up.

Revisions to the tax code will be proposed to curtail certain tax abuses, remove obsolete incentives, and enhance revenues, while maintaining incentives for economic growth. The proposals will result in additional tax receipts of $3 billion in 1982, $8 billion in 1983, and $11 billion in 1984.

The Administration is renewing its proposals for user charges to recover part of the costs of federally-provided Coast Guard, inland waterway, port, and air services from those who benefit from them. The proposals are fair. They will enable the Government to recover a portion of the costs of providing special services to owners of yachts and commercial vessels, to airlines, and to private pilots. The Congress has so far ignored these proposals, even though they seek to reduce a form of economic welfare for the less than needy. Savings of $980 million would be achieved in 1982 outlays, 30% of the cost to the Government of providing the services.

Budget authority requested for defense is reduced by $7.6 billion for 1982 with outlays reduced by $2 billion for 1982, $5 billion for 1983, and $6 billion for 1984. This reduction is the maximum that can prudently be made in this area. It involves stretch-out in selected procurement programs and accelerated retirement of older, costly to maintain, and less capable units. Our goal of a strong national defense is not compromised. The reductions do not affect the high priority readiness initiatives begun in 1981; military personnel goals for enlistments and retention, and pay; strategic force improvements; and improvements in our rapid deployment force capabilities.

For nondefense discretionary programs, the President is submitting to the Congress revised 1982 appropriation requests reflecting 12% across-the-board reductions in each department and agency. Exemptions from the 12% reduction were made for only a very few programs, including (but not limited to) peacekeeping forces, direct Veterans Administration hospital care, and the Immigration and Naturalization Service, with partial exemptions for several law enforcement and criminal justice functions. The 12% reductions total $18.7 billion in 1982 budget authority, and reduce estimated outlays by $17.5 billion over the 1982-84 period.

Table 8.—Revised Budget Outlook
(fiscal years; in billions of dollars)

	1982	1983	1984
September revised outlay estimates..........	722.4	769.0	818.8
New savings proposals:			
12% across-the-board FY 1982 cut.....	8.4	5.3	3.8
Defense slow down.....................	2.0	5.0	6.0
Entitlements reform...................	2.6	10.0	15.0
Subtotal...........................	13.0	20.3	24.8
Revised outlay estimates, net of new savings	709.3	748.7	794.0
September revised receipt estimates.........	663.2	706.1	760.0
Proposed revenue enhancement through tax code changes..............................	3.0	8.0	11.0
Revised receipt estimates, with new proposals..................................	666.2	714.1	771.0
Future savings to be identified for FY 1983-1984...............................	—	11.7	23.0
Deficit targets.............................	43.1	22.9	—

The budget control measures in the President's new program -- including reductions in 1982 appropriation requests, entitlement program reforms, and tax code revisions -- would produce budget savings of $16.0 billion in 1982, $28.3 billion in 1983, and $35.3 billion in 1984. These measures, together with the additional savings to be achieved during the development of the 1983 and 1984 budgets, will result in deficits of $43 billion for 1982, $22 billion for 1983, and a balanced budget in 1984.

Can the Gap Be Closed?

Setting aside receipt enhancement proposals and the proposed slow down in defense, further budget outlay reductions totaling $11 billion in 1982, $27 billion in 1983, and $42 billion in 1984 are required to achieve the President's balanced budget goal for 1984. It has been suggested that feasible and realistic options to achieve savings of this magnitude are simply not available. I strongly and fundamentally disagree with that contention.

More specifically, it is frequently argued that after defense, social security and interest on the public debt, there are few savings opportunities left in the budget. If so, there would be little if anything left to provide a base for further budget reductions. As the accompanying table indicates, a substantial budget base, totaling $343 billion in 1984, remains after excluding the "big three" and adjusting for certain offsetting receipts that artificially lower the apparent size of the budget aggregates. From this budget residual, reductions of $42 billion are needed. This would be a cut of 12% — hardly a "slashing to the bare bones."

Table 9. — 1984 Budget Outlays
(dollar amounts in billions)

September base	819
Adjustment for offsetting receipts	30
Subtotal, September base (gross)	849
Less:	
National defense	255
Net interest	68
Social security	183
Remaining budget base:	
Major entitlements	187
Other (mostly discretionary) programs	156
Subtotal	343
Reductions needed in nondefense programs	42
Reductions needed as a percent of remaining budget base	12%

Reductions in Major Nondefense Entitlements Programs

The President has proposed that at least $15 billion of the $42 billion in needed 1984 outlay reductions be made in major nondefense entitlement programs. This proposed reduction involves an 8% reduction in a group of programs that has increased dramatically during the past 25 years.

During the 1955-1965 period, these entitlements -- which are listed in the accompanying table -- accounted for just over 11% of total budget outlays and were about one-fourth the size of defense spending. Between 1965 and 1975, outlays for these programs grew at an average annual rate of nearly 20%.

By 1975, nearly one-fourth of the total budget went to these entitlement programs. Spending for these programs increased by 13% per year through 1981.

Under the President's revised budget proposals, the rapid increase in spending for entitlements other than social security would be slowed. A thoroughgoing Administration review of these entitlement programs, leading to a comprehensive proposal for entitlement program reform, will be transmitted to the Congress in the near future.

Table 10 — MAJOR NONDEFENSE ENTITLEMENT PROGRAMS
(outlays; dollar amounts in billions)

	1955	1965	1975	1981	1982	1984
Assistance payments program	1.4	2.8	5.1	8.5	7.4	7.4
SSI	—	—	4.8	7.3	8.1	8.6
Food Stamps	—	*	4.6	11.3	11.0	9.6
Child nutrition and special milk	0.1	0.3	1.6	3.5	2.8	3.5
Refugee assistance..	—	*	0.1	0.5	0.6	0.5
Energy assistance ..	—	—	—	1.8	1.4	1.4
Medicaid	—	0.3	6.8	17.1	20.6	23.0
Housing assistance..	0.1	0.2	2.1	6.8	7.9	10.3
VA non-service pensions	0.8	1.9	2.7	3.8	4.0	4.4
Medicare-HI	—	—	10.6	28.6	33.3	41.7
Medicare-SMI	—	—	4.2	13.0	14.8	19.3
Civil service retirement	0.4	1.4	7.1	17.7	19.8	24.4
Foreign Service retirement	*	*	0.1	0.2	0.2	0.2
Black lung trust fund	—	—	—	0.8	0.8	0.8
FECA (special benefits)	*	0.1	0.2	0.3	0.3	0.4
VA Education	0.7	0.1	4.6	2.4	2.0	1.3
VA burial benefits and related	0.1	0.1	0.2	0.2	0.1	0.1
VA service-connected compensation	1.8	2.2	4.7	8.4	9.5	10.9
Student loan insurance	—	—	0.1	2.8	2.7	2.7
Unemployment assistance	2.1	2.6	12.8	20.2	19.4	16.6
Total	7.5	11.8	72.3	154.9	164.3	187.2

Note: Prior to 1972, assistance to the aged, blind, and disabled is included under the assistance payments program (AFDC).
—: Program not in place.
* $50 million or less.

Reductions Required in Other Programs

Remaining reductions needed beyond those to be achieved by reforms of major entitlement programs would total up to $27 billion for 1984. Of this amount, savings of $4 billion are achieved as a result of the 12% across-the-board reductions proposed for 1982 appropriations. That leaves $23 billion in savings yet to be proposed. Most of these savings will come from the remaining $152 billion budget base of mostly discretionary programs.

Some portion of the unspecified savings can be achieved by further reductions in Federal credit activity. The deleterious effects of Federal credit activity on the level of private sector investment and interest rates is a primary concern of this Administration.

Payments for individuals not included under the major entitlements category include various health and medical care programs of the Department of Health and Human Services and the Veterans Administration, student assistance and others.

Some of these programs overlap, or provide benefits that duplicate those provided under the major entitlement programs. For example, the average family under the special supplemental food programs (WIC) gets $1,700 per year in food and other benefits. At the same time, 40% of these families get an average of $1,475 in food stamps. A careful reexamination of the current eligibility requirements and funding levels for these programs will be undertaken as part of the 1983 budget review process.

The other Federal program category includes foreign assistance, general science and space research, the strategic petroleum reserve and other energy activity, Corp of Engineers and Bureau of Reclamation construction programs, rail and air transportation programs, law enforcement activities, health, education and training programs, agriculture price support and research programs, and other domestic Federal operations. Examples of excesses, inconsistencies and overlap in these programs are numerous.

For example, we will spend billions on agriculture price supports due to over-production, while the Departments of Interior and Agriculture will spend billions on irrigation and reclamation projects that will encourage even more production. The Jobs Corps program costs $13,000 per trainee per year, or $10,000 more than average tuition cost at a state university. This includes $2000 per trainee for "pocket money."

Rather than continue on with a litany of examples, let me just conclude this discussion by saying that I think a careful government-wide review of the kind provided by the upcoming fall budget review process will be able to find 15% in savings from these programs.

The approach that this Administration is taking is balanced, fair, and feasible. It can restore equilibrium between acceptable tax rates and budget outlays. This is the key to healthy financial markets and non-inflationary economic growth. Single-factor solutions — deep cuts in defense, delay or rescission of the income tax cuts, enactment of new taxes, etc. — are dangerous, economically destructive, or impractical.

Some have suggested, for example, that a substantial part of the budget gap should be closed by reducing the planned defense build-up. To close roughly half of the FY 84 gap would require a further defense outlay reduction of about $30 billion.

But reducing defense outlays by such a large amount, or even $20 billion, would require drastic program reductions in 1982, 1983, and 1984 from our current plans. That level would put us very close to the trend line of past defense budget policies of 1977 through 1981. Defense policies and budgets of that period were clearly inadequate to meet the challenges of an increasingly unstable international environment. Without some improvement in our deteriorating defense posture, we would not be able to regain our margin of safety nor fulfill our foreign policy commitments. Specifically, a reduction of that magnitude would require a decrease of over $125 billion in budget authority for 1982 through 1984.

As a consequence, the Administration's defense objectives, such as improved strategic forces, a 600-ship Navy, and improved readiness, would not be merely delayed — they would be unachievable.

Similarly, although the closing of various tax loopholes and abuses may in some cases serve a useful purpose to remedy defects in the tax code, pursuit of this course of action alone will fall way short of the balanced budget objective for 1984. As you know the President has under review a series of changes in the tax code to remedy certain abuses which have built up over time. These changes, however, were they all to meet successful Congressional disposition, would only yield $11.2 billion in additional receipts for 1984, falling way short of the current budget gap. On the other hand, to achieve revenue gains of approximately 5 times this amount would lead us to an exercise which at best would be unfeasible and impractical and at worst might create serious disruption to the legislative and political processes.

Another quick fix suggestion is the rescinding or deferral of the scheduled tax reduction. This argument fails to recognize the central role that incentives play in the President's program for economic recovery. A flip-flop or turnaround on the tax package would have a chilling effect on saving and investment incentives and the willingness of investors and business to undertake risk. A new element of significant uncertainty would be introduced, forming a sizable impediment to new investment and business formation. Consistency in policy is a virtue; inconsistency and frequent U-turns always serve to undermine credibility. Moreover, deferral of the tax cut will inhibit economic growth and raise unemployment, thus worsening the budget situation through an increase in spending and a reduction of receipts.

As a final comment, let me emphasize once again the President's commitment to follow through in the effort to implement the budget control plan. To the Administration, nothing is more critical to a revival of long-term sustainable economic growth and job creation than immediate actions to restore the Nation's financial health. If we are to change public expectations and reverse the attitude of skepticism which survives as a legacy from past policy errors and a long string of broken promises, then it is incumbent that immediate action be taken to bring the 1982 budget into line and enhance fiscal credibility.

Pointing the finger at the marketplace is no answer, nor can attitudes be changed through gimmicks or quick fixes. Only concrete actions will be sufficient. The burden of proof rests with government in Washington. The momentum has begun; it is now our responsibility to mount an effective and convincing follow through.

Senator **Hart**. Mr. Chairman, could I just correct the record? I do not know which committee member Mr. Stockman was referring to voting against the tax bill, but I was one of them. I think the distinguished Senator from South Carolina was another.

Mr. **Stockman**. Two. I amend that to two.

Senator **Hollings**. A 100-percent improvement.

DEFICIT ESTIMATES FOR 1983 AND 1984 MORE IMPORTANT

Chairman **Domenici**. Might I ask if one of the members of the majority would accommodate by making sure that they vote before the last buzzers so I can go vote then, and we will not recess. So, if one of you would do that, you can chair when I go vote. We will just keep it going because someone will be here for questions.

I have just two or three questions, Mr. Stockman, and then I will yield.

From the standpoint of action to be taken this year, as you envision it, procedures for accomplishing it are still undetermined, a matter for Congress to decide. The one procedure you have suggested, and the President has, would be a veto of appropriation bills that exceed new targets. What is the most important thing we can do to make this economic recovery program work?

Let me first give you my view and see if I have it right and, if so, how your program for cuts fits. It appears to me that a compelling majority of your cuts recommended would have impact, could have impact primarily in 1982. You would certainly agree with me that with appropriations the primary impact is a 1982 impact. Defense slowdown is an 1982 impact. And we have to wait and see how it spends out.

I believe it is more important that we address the budget deficit estimates for 1983 and 1984 as soon as possible, taking as much of a bite out of those as possible before we leave here this year. I do not believe it is the 1982 deficit that primarily causes concern in the money markets, causes a lack of credibility. I believe it is the cumulative deficit shown without a mechanism for getting those cuts down.

Would you agree with that or disagree? If you agree, how do you expect us to get the kind of cuts that I have just described if we principally focus on appropriations?

DO NOT MINIMIZE IMPORTANCE OF 1982 DEFICIT

Mr. **Stockman**. Mr. Chairman, I think I would basically agree with your analysis of the problem but I would not minimize the importance of the 1982 deficit. I think it is viewed by the financial markets as a leading indicator of whether or not there will be the political and legislative capacity to deal with the problem in 1983 and 1984. Therefore, it is important to address the 3-year problem, but to simply ignore 1982 and let it soar out of sight I do not believe would be an acceptable procedure, nor would it build the kind of confidence in the financial markets you are looking for.

OUTLAY SAVINGS

In terms of our proposal, I think your analysis is partially correct; but I would like to extend it one step. If we were to succeed in cutting appropriated programs by 12 percent this year, only half the outlay savings would be achieved in 1982. We have proposed $8.4 billion in outlay savings in 1982, but $17.5 billion is the total saving from this proposal over the 3-year period. So, you would get additional built-in outlay savings simply, as you well know, because some of these programs spend so slowly. Beyond that, assuming you lowered the base of program activity or budget authority in 1982, it might be somewhat easier in the annual process in 1983 and 1984 to hold to similar levels.

In defense, yes, it is true that the outlay savings would occur in 1982 at $2 billion. But I think a very clear indication was given here by the President that $13 billion from our previous estimates is the target for the next 3 years. These new levels of defense outlays—$182 billion in 1982, $215 billion in 1983, and $243 billion in 1984—will become binding outlay ceilings that we will enforce and live with as part of the effort to close the budget gap. So, I think that that is a 3-year savings as part of the scheme that you are talking about.

PROCEDURE RESPONSIBILITIES

Finally, I would say, to directly respond to your point on procedure and how to move ahead, I believe you need a framework by which all of these complicated items that we have proposed in all of the different committees involved in the process could work under some kind of common plan and common distribution of responsibilities.

I would note that in our own proposal, which is split among domestic discretionary programs, the defense slowdown, the entitlement reform package, and revenues, it would involve 13 regular appropriations subcommittees, 5 to 6 major jurisdictional committees with entitlement jurisdiction, the tax-writing committees obviously, and probably 4 defense appropriating and authorizing committees.

It seems to me that to deal with a 3-year package that involves that many pieces in the process suggests that some mechanism, perhaps the second budget resolution, would provide a vehicle for the appropriate allocation of this problem so that all parts of the institution could move forward under a policy design that the members chose.

REVENUE ENHANCEMENT

Chairman DOMENICI. Let me be more specific. Would it be correct that your revenue-enhancement suggestion, whether the Congress ends up with that amount or not, would you want the revenue enhancement passed 1 year at a time? Or would you expect to put in place a revenue-enhancement package that equals the sum of your parts?

Mr. STOCKMAN. I think we would be looking for a multiple-year, permanent change in the tax code. By definition, if you are removing obsolete incentives or eliminating abuses, those become permanent changes. Certainly the policy changes ought to be calibrated to achieving $11 billion at least in 1984 and similar amounts——

ENTITLEMENT REFORM

Chairman Domenici. My same question as to entitlement reform. You have a savings of $3 billion in 1982, $10 and $15 billion respectively in 1983 and 1984. Is it the administration's position that that should be done piecemeal, where we effect $3 billion this year? Or do you anticipate and are you asking us to package that so it has multiple year savings of $3, $10, and $15 billion respectively?

Mr. Stockman. It would be a multiple year objective. Since, again, these are permanent law changes, the $3 billion figure for 1982 is more happenstance than anything else. But we do not imagine that you could get these implemented until late in the fiscal year. What we should be looking at is a $15 billion policy-level target for the third year out, 1984.

FUTURE SAVINGS

Chairman Domenici. With reference to future savings yet to be identified, the President's proposal does not contemplate any of those savings that occur in 1982. Is that correct?

Mr. Stockman. Under our present proposal, that would be correct.

Chairman Domenici. So, is it fair to say that changes in substantive law to effect those cuts could wait until 1983? Or do you have in mind that some be made before this year is over?

Mr. Stockman. It would be our intention that those would be reserved for the process in 1983 and 1984 and that implicitly they would come from discretionary program savings of one type or another that could be dealt with during the annual process. But it would not have to be done that way. That is just a suggestion that we have made at the present time.

Chairman Domenici. Mr. Stockman, I would assume that future savings to be identified in 1983 and 1984, which constitute $12 and $23 billion respectively of your proposal, that a significant portion of those savings would have to come from entitlements. Would you agree?

Mr. Stockman. Well, I do not think I would quite agree with that since $15 billion of the $42 billion savings required on the outlay side are already included in our plan to come from entitlements. The reason that we have specified the entitlements savings is that, again, you are dealing with permanent law. Presumably, if we get changes into place this fall or early next calendar year, those would grow to the dimension that we have indicated. I think it is possible to conclude that you would get more entitlements savings, but a large share of the $23 billion, I think, would have to come from discretionary programs.

CUT DISCRETIONARY APPROPRIATIONS 12 PERCENT

Chairman Domenici. How can that be? Are you then telling us that we make a 12-percent across-the-board cut in discretionary appropriations other than defense, which you have itemized differently? You have got an entitlements savings and a future savings to be identified equal $23, $33, $35 billion. Are you suggesting that a significant portion of that come out of discretionary appropriations also?

Mr. Stockman. I would not attempt today to specify down to the last billion dollars where. It seems to me, as I look at the entitlement programs, $15 billion is a very difficult amount to achieve without undesired effects. Perhaps it could go higher. Certainly you and other members of the committee may have ideas on how that could be done.

Chairman Domenici. I really submit to you, Mr. Stockman, that that is the most incredulous part of the package because, if you look at the distribution of Government expenditures, if you effect the discretionary cuts that you have described, you will be very close to that whole package growing at a negative rate of around 5.5 or 6 percent. That means that we will have gone from an average of 13- or 14-percent increase to 5- to 6-percent decrease, and yet entitlements will still be growing—just off the top of my head, looking at these numbers—at an annual rate in excess of 9.5 percent. At that point in time, they will still constitute, with interest, 53 to 57 percent of the budget.

I am not argumentative, but it appears to me that, if we are going to look at something here in a resolution, it has to be realistic in terms of how we can effect and, at least by function, indicate those savings. I do not see where $35 billion of additional cuts is going to come out of discretionary appropriations.

Mr. Stockman. Mr. Chairman, I do not think we are quite proposing that. We have indicated you would need $42 billion in savings from all nondefense spending programs by our analysis of the 1984 deficit.

We have proposed to take $15 billion of that out of entitlements other than social security. You would automatically get a savings of $3 or $4 billion in 1984 simply as the outlay effect of this 12-percent cut taken in 1982.

I would point out, though, if you were willing to hold down the discretionary portion of Government—maybe not on a pro rata basis, but deeper in some places and no cuts at all in others—but on an average 12-percent basis for the next 3 fiscal years, you would automatically get most of that $23 billion in outlays that we are talking about because it builds each year. It pyramids. You would get $8 billion in 1982; by 1983 it would be $13 or $14 billion; and by 1984 it would be $17.5 billion. That is what you would get by maintaining that policy for 3 years although you might want to change the program mix.

DEFENSE CUTS

Chairman Domenici. Senator Tower asked me to ask you this question for the record.

Do you support the cuts in defense as stated by the President? Are you recommending to this committee that those cuts as recommended be the extent of the cuts in military preparedness?

Mr. Stockman. Yes, Mr. Chairman, I strongly support those cuts. I believe that that is a wise and justified decision and that it would not be desirable to solve this problem by deep forays into the defense budget. That has been done for a decade. If we attempt to alleviate the fiscal pressure by reverting to that tactic, we are going to leave the defense of this country seriously impaired.

NEGOTIATION AND COMPROMISE

Chairman **DOMENICI**. Mr. Stockman, you have indicated that the President is obviously asking for a dialog. You have repeated here today that this is the mix that you have recommended in his behalf. If I read you correctly, you were implying that maybe there are other mixes that might be appropriate. Is that a fair statement?

Mr. **STOCKMAN**. Mr. Chairman, we believe that that is the best mix. We do not believe that it would be wise to cut defense any further. We do not believe it would be wise to solve this problem with huge increases in revenue. Nevertheless, the President has issued an invitation to the Congress to jointly address the problem. We realize that among reasonable men there are going to be some differences of opinion.

Chairman **DOMENICI**. Mr. Stockman, let me then correct that statement and say, but for defense, which you have said and repeated you do not think it would be wise to cut any further, the mix that you have discussed includes $3 billion in 1982 in revenue increases, $8 and $11 billion respectively for the additional years. Is it fair to say that those numbers are also negotiable from the standpoint of a different package? If not, would you tell us why not?

Mr. **STOCKMAN**. Mr. Chairman, I think the most urgent priority at the moment is to hold the deficit in 1982 and demonstrate how we are going to close the gap in the out-years. Failing that, we will not get interest rates down. We will not restore confidence in the financial markets. And this whole economic plan that we have launched could well be interrupted in terms of its ability to bring about the results we want.

Therefore, I do not think we are in a position to nitpick over details. We are concerned about a cooperative effort with the House and the Senate to get the bottom line changed and the gap closed.

Chairman **DOMENICI**. Well, does that mean that it is negotiable?

Mr. **STOCKMAN**. Well, I do not know of any bill past or present that was ever passed in a body of 535 Senators and Representatives and an executive branch in which there was not negotiation and compromise. Clearly, that occurred with the reconciliation bill. It happened in the tax bill. And I do not see any change of pattern in the future in terms of how we get final results.

Chairman **DOMENICI**. I am going to yield to Senator Biden so I will not miss the vote.

Senator **BIDEN**. Thank you, Mr. Chairman.

Hello, Mr. Stockman.

Mr. **STOCKMAN**. Good afternoon.

IMPORTANT TO REDUCE DEFICIT IN 1982

Senator **BIDEN**. We have never met. It is good to see you in person. I have been the one not here, not you. I suspect you probably wish you had not been some of the time.

Let me follow up on what Senator Domenici just asked you and see if I understand your last comment. The most important thing, as you see it, is to get that deficit down this year in the fiscal year 1982 budget. Is that correct?

Mr. STOCKMAN. It is important but not the only objective. We must not permit, in my judgment, another huge overrun in outlays in the deficit for this fiscal year because, if that occurs, it will be a signal to the financial markets that we have no capacity, intention, or will to solve the 1983 and 1984 deficit problem. Under those circumstances, we are going to be unable to get interest rates down and get this economy moving.

DISALLOW TAX CUTS FOR 1982

Senator BIDEN. I do not disagree with that. As a matter of fact, I think you are absolutely right. I guess the difference I might have—and I am not sure it is a difference—is that, if in fact the interest rates are going to, in effect, yield only to a show of resolve on the part of the administration and the Congress to do something about the deficit and the judgment as to how well we are going to deal with the deficit long term will be made, in the first instance, in 1982, then why is it that the President, in light of all the circumstances, many of which have changed and many of which, as you point out, are difficult to estimate, in the first instance, why is it that we would not do the most logical thing front-end, the thing that the supply-side theory could most yield to front-end; and that is deal with the tax cut in a big way the first year, 1982?

Mr. STOCKMAN. I am not sure that I understand what you are recommending.

Senator BIDEN. Well, let us say if we just flat-out disallowed the tax cuts for fiscal year 1982 or allowed it only in the corporate sector for business and eliminated all the individual income tax, across the board, not just rich folk, poor folk—everybody. I mean——

Mr. STOCKMAN. Yes, Senator, I understand your question now. I will try to point out very quickly why I think that would be undesirable.

The President was elected by saying that he would cut taxes 30 percent beginning January 1. But——

Senator BIDEN. Just a moment. I think you all are wrong on why he was elected. He was elected, but I do not think it ever was because he promised he would cut taxes 30 percent. But that is something I think you have all locked yourself into unnecessarily. But go ahead.

Mr. STOCKMAN. Well, that is historical fact that can be debated later. But it is an accurate fact that he proposed——

Senator BIDEN. We can debate the facts later.

ADMINISTRATION WILLING TO MAKE COMPROMISE AND MODIFICATIONS

Mr. STOCKMAN. It is an accurate statement that he proposed a 30 percent cut beginning January 1.

Now, as part of this political and legislative process, we are willing to make many compromises and modifications along the way for the greater good of getting a product that there was consensus around. And in that process the depth of the tax cut was reduced to 25 percent. The effective date was delayed for 9 months, until October 1 of this year. And now to propose that 3 or 4 days after the first meager installment of that long-overdue reduction is in place, to delay the second installment seems to me to send a very strong signal to the American people that we really do not mean this tax cut after all. If we lose our willingness or our courage or our desire to trim back the cost of Government, we will always solve the deficit problem by slipping the second or third installment another 3 months or another 6 months. I do not think that that is a good way to start out in fiscal year 1982, the first budget year under this new program, by saying we really did not mean the tax cut; we cannot cut spending, and we are going to defer it indefinitely. I think it would have a very negative economic effect, to say nothing of being viewed by the American people as a betrayal of what Congress and the President jointly said had been delivered to them.

Senator BIDEN. Let me say this. Just think in retrospect how lucky you were that you did only make it 25 percent and did delay it 9 months. Just think the world of hurt you would be in now if that had not happened.

Mr. STOCKMAN. No; I do not think we would be in any different position, Senator. The reason for it was that the revenue, the static revenue loss is much lower because of the stretch-out. But the Congress, in its own wisdom and for reasons we understand, decided to load the bill with a whole variety of new provisions, whether it is the marriage penalty, good case for it; oil provisions, in the view of some, good, in the view of others, not so good. All of those other provisions resulted in a total revenue loss equal in magnitude to what we had originally proposed as a clean, incentive-oriented tax cut for individuals and businesses. So——

Senator BIDEN. Are not you faced with the problem of, in a general sense at least, worrying understandably that the American people would think that the President has gone back on his promise about cutting taxes? Are not you facing an equally difficult dilemma of dealing with what the American people also think was a promise: that there would be a balanced budget, that there would be no cuts in social security, that there would be significant increases in defense? I mean, are not you sort of caught between the rock and a hard spot whichever one of those you choose?

I mean, you promised all of those things. And I am not being facetious.

You and I are the same generation. We both shared only one experience together that I know we shared the same view on, and that was Vietnam. And this sort of reminds me of an economic Vietnam. This reminds me of, you know, if we do a little more, we can Vietnamize the countryside. If we just cut a little more here, if we add a few more troops, we can win.

There are so many things that remind me, even to the point that, you know, the first folks to turn on you all are your folks. It reminds me. When I heard the President making ad hominem arguments against Wall Street, the first thing that popped in my mind was Johnson taking on the academics, who had been his strongest supporters. And I am afraid we are getting ourselves into the same dilemma: the President made a promise; he doesn't want to go back on the promise even though it might make economic sense to do so. Just like Johnson making a commitment, he was not going to be the first guy to lose a war. He was not going to be the one to back off.

ADD-ONS TO THE PRESIDENT'S BUDGET PLAN

I wonder where it stops. For example, you know, on table 4 let me make sure I am correct here. On table 4 of your statement,[1] you list $14.4 billion of add-ons to the President's budget plan that will result from "effect of enacting appropriations at authorized levels." Yet, this additional spending is not included in your September base-line outlay figures and the resultant "potential budget deficit" figures on table 5 of your statement, which you list on table 5.[2]

I assume there are no savings in the President's proposal to offset these increases in his budget plan if they occur. You say that these add-ons of the President's plan are a result of following the ceiling set in reconciliation which is, in effect, Congress' budget plan. So, it seems to me that either Congress has to find an additional $14.4 billion in savings, which were not included in the budget plan, or else the President's deficits for these 3 years will be $14.4 billion higher than he is now planning on.

Is not it sort of a risky plan for us to follow, that we end up in a situation that we are not sure of where we are going to get these savings? The reestimates, you point out, you were what, understandably, $10.5 billion—what is the figure here?

Senator **Grassley**. Senator Biden, the red light has come on. I guess, because I am the next one down the line here, I am supposed to watch the time.

Senator **Biden**. That is about as diplomatic as you have ever been with me, Senator. I tell you what; in that case, I yield.

Senator **Grassley**. Thank you.

Senator **Biden**. I will be back.

Senator **Grassley**. Besides, not only am I being the next in line, but I am the next one to ask questions.

Senator **Biden**. I understand the motivation.

Senator **Grassley**. I hope I was acting on the authority of the Chair.

Senator **Biden**. You are. Go right ahead.

MONITORING OUTLAYS

Senator **Grassley**. One of the things that we are concerned about now is the extent to which Congress is appropriating more money than is allowed in the budget resolution. As a member of the Budget Committee and fiscal conservative, this concerns me greatly.

Do you have any means of monitoring potential outlays more closely and in some administrative way checking on this? More specifically, do you have a system for monitoring outlays during the year which would allow you to take management action in order to slow spending when outlays begin to run ahead of plan?

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[1] See p. 215.

[2] See p. 216.

Mr. STOCKMAN. Senator, let me suggest that there are some limited things that can be done purely through executive or administrative discretion to control the timing of outlays. You can control the timing, for instance, of asset sales and thereby decrease outlays one year and increase them another year.

To some marginal degree, you can control the rate at which bills and Government contractors are paid.

But, basically, under the Impoundment Control Act of 1974, the President, and the executive branch have very little discretion to manage outlays if policies are adopted that cause spending to be higher. We have created a system where, in order to reduce outlays and reduce the deficit, congressional action of one type or another is necessary. That is probably a desirable decision. But it does put an enormous burden for timely and sometimes difficult action on the Congress. And I think that is what we are faced with here as exemplified by Senator Biden's question. No one ever said it would be easy to rebuild the national defense—it was neglected for 10 years—or to cut the tax burden on our economy, which was at a historic high and having a severe stifling effect on growth, and to shrink at the same time the overgrown commitments on the domestic side of our Government. We said it could be done, and it would be difficult. And I think that is now what we are confronted with, and the action has to start here.

Senator GRASSLEY. Then there is no administrative power to make up for the shortcomings of Congress overspending?

Mr. STOCKMAN. That is right.

Senator GRASSLEY. Except for the power of veto.

Mr. STOCKMAN. Except for a few months or the power of veto.

MANAGING TIMING OF OBLIGATIONS BY QUARTERLY APPORTIONMENT

Senator GRASSLEY. OK. Well, what about the quarterly allotment? Is that any help?

Mr. STOCKMAN. The quarterly apportionment is a way of managing the timing of obligations——

Senator GRASSLEY. But it does not actually save any money——

Mr. STOCKMAN. No.

Senator GRASSLEY [continuing]. Below what Congress could possibly otherwise appropriate.

Mr. STOCKMAN. As a matter of fact, if we apportioned less than the Congress appropriated, then we would have an impoundment situation, and we would either have to send a deferral or a rescission message; but, again, that would involve the Congress.

Senator GRASSLEY. What about the massive amount of money that is spent during the last month or 6 weeks of a fiscal year? Is there any administrative way that situation can be managed or controlled?

Mr. STOCKMAN. Well, through better apportionment and obligation patterns, you would not have it still available at the end of the fiscal year. However, if it is 1-year money and the Congress has appropriated it, it must be obligated or we have an impoundment situation.

Senator **Grassley**. In the final analysis then, it has got to go through the rescission process, which involves Congress in the process?

Mr. **Stockman**. That is right.

BASIC COURSE OF MONETARY POLICY

Senator **Grassley**. On another matter, in your memo to the President last November or December, which was entitled, "Avoiding a GOP Economic Dunkirk," you state that, "critical lynchpin" in the whole program is a stable and prudent monetary policy.

Chairman Volcker was sitting where you are now sitting about 3 weeks ago. He agreed. In this morning's Post, I read that there is some controversy over the amount of restraint that is necessary. The article quotes a senior budget official as saying that money has not been too tight. Secretary Regan has once again commented, and I first read his comments last week, that the Fed should consider easing monetary policy.

Would you care to comment on the current policy? Do you think it is as it should be? Is it what you envisioned when you wrote your memo to the President in November?

Mr. **Stockman**. Well, Senator, let me say first that these suggestions that have appeared indicating a difference of opinion are simply newspaper chatter and intrigue. There is no difference among any of the senior economic policymakers within the administration over the basic course of monetary policy.

Essentially, we believe that the Fed has done a relatively good job under the circumstances over the last 10 months or so in bringing money supply growth down to a rate that is compatible with wringing the inflation out of our economy. Now, when you move from the basic policy direction to arcane arguments about whether M1-B, which is just one of the four or five measures of money growth that you can use, has been above or below the target for the last 3 weeks, you know there are going to be all kinds of different views on that. But I think it is not fruitful or worthwhile to engage in a 3-week or 5-month argument over the course of M1-B.

Basically, we know that the deficit today is the major factor driving up interest rates and that, if we want to allow the Fed to stay on the track of reducing money growth and keeping inflation coming down, which is coming down at a very healthy and encouraginq rate, then we have to remove that deficit in order to alleviate and abate the interest rate pressure.

It is really a fiscal debate today. I do not think there is much debate about the general direction of monetary policy.

Senator **Grassley**. Is your view any different today from what you wrote in November?

Mr. **Stockman**. No. I think that what the Fed is doing basically conforms with what I suggested in my memo back then.

Senator **Grassley**. Mr. Chairman, thank you.

Chairman **Domenici**. Senator Exon, you were going to be last, but now you are first.

INTEREST RATES

Senator **Exon**. The last shall be first.

Welcome, Mr. Stockman. I wanted to get into the matter of interest rates, which I know is plaguing our economy in Nebraska and throughout the Nation. I know you are concerned about it.

For the record—and I have been asking this question of every witness that we have had before our committee—what are you looking for in the T-bill rate, the prime interest rate, use whatever figure you want? I think that the prime is probably the easiest. The prime is at, let us say, 19 percent today. What do you anticipate the prime will be on January 1, 1982?

Mr. **Stockman**. Senator, the last thing in the world I would do is predict the prime rate on January 1, 1982. I do not think there are any experts inside or outside of government that could give you a reliable figure on that. I would suggest the direction will be down. The reason for it is that, at least for a temporary period, there appears to be a slackening of demand for private credit as the economy stalls out in the next couple of months.

Where it goes beyond that for the next year or 2 years is critically important. In my view, that will depend almost entirely on whether we demonstrate credible and major progress in closing the deficit this year and in future years. For the T-bill rate on which we must make our budget projections, we are now suggesting an average of about 12.5 percent over the course of calendar year 1982. That is just a planning figure. Now, the prime rate would be somewhat above that.

T-BILL RATE

Senator **Exon**. Well now, that is a rather interesting figure. Let us go into that. Hopefully, you can keep your answers as short as possible. I do not mean to rush you.

You are now testifying that the T-bill rate will average 12.5 percent for 1981 fiscal year?

Mr. **Stockman**. No, no, for calendar 1982.

Senator **Exon**. For calendar 1982.

If I remember correctly—correct me if I am wrong—did you not indicate in July last that for the rest of 1981 and for all of 1982 that the T-bill rate would average 10.5 percent?

Mr. **Stockman**. That was the figure, I believe, in our midsession forecast for the calendar year.

Senator **Exon**. So, you are saying that you—if I understand you correctly, you are saying that you have raised. In July you told us 10.5 percent for calendar year 1982. Now you are saying it is going to be 12.5 percent?

Mr. **Stockman**. 200 basis points, yes.

Senator **Exon**. And, if my calculations are generally correct, that means that we will be paying out another $15 to $18 billion in interest as a result of your latest figures?

Mr. **Stockman**. No; that is not correct.

Senator **Exon**. What is the correct figure?

Mr. **Stockman**. The additional interest cost in 1982 would be about $5.6 billion.

Senator Exon. Well, Mr. Stockman, I cannot understand the way you figure because I remember well last January the administration was talking about an 8.9-percent average rate. Then in July you raised that to 10.5 percent for the rest of 1981 and all of 1982 on average. And I remember very clearly at that time that that increase for the rest of 1981 and all of 1982 cost us $17.1 billion. This only $5 billion cost to the taxpayer on a raise from 10.5 to 12.5 percent on average for 1982 cannot be a correct figure.

Mr. Stockman. Well, yes, it can, Senator. The $17 billion figure that you use, I think, is erroneous. In our July midsession estimate we raised net interest cost by about $10 or $11 billion. But the second thing to remember is that there is a timing question. The earlier that the interest rate is higher, the more of the debt structure you have invested at that higher rate. So, if I know 2 years ahead of the fiscal year that the interest rate is going to be higher, that will then result in a much higher outlay estimate.

This incremental change and the expected interest rate average for 1982 does not add a substantial amount of additional outlays.

Senator Exon. But you are testifying as far as I know for the first time now—maybe you have said it before—but you are testifying at least now that the average figure for 1982, that was supposed to be 10.5 percent, has now gone up to 12.5 percent. Is that correct?

Mr. Stockman. That is correct.

Senator Exon. And that is only going to cost about—only. That is going to cost $5 billion?

Mr. Stockman. $5.6 billion.

12-PERCENT ACROSS-THE-BOARD CUT

Senator Exon. $5.6 billion.

One other question: this 12.5-percent across-the-board cut that you have suggested——

Chairman Domenici. No; it is only 12 percent, Senator.

Senator Exon. Twelve percent.

Have you outlined those in specifics, as I think is your responsibility? Or have you just taken a meat ax and said it is 12 percent, you figure, from there?

Mr. Stockman. We have sent to both Appropriations Committees and, I believe, the Budget Committees, a complete listing of some 12 or more pages of each of the 1,100 appropriation accounts of the budget. The changes are specified down to the last dollar in each of those accounts, ranging all the way from Army Corps of Engineers projects to education grants.

Senator Exon. If I understand it correctly, that 12 percent slash that you have recommended in addition to what we have done before is based upon the first figures on the total budgets rather than those that came out of the reconciliation and budget process before we left for the August recess. Is that correct?

Mr. Stockman. Yes. The reason for that was that the reconciliation bill, in terms of authorization ceilings for appropriated domestic programs, was $3.5 billion above what we requested. Had we cut from that level, we would have gotten back to March but not much further, and we would have been left with a deficit problem that was intolerable in terms of its size.

Senator EXON. Thank you, Mr. Chairman. I will be back with a second round.

Chairman DOMENICI. Thank you, Senator Exon. Senator Quayle?

TARGET BUDGET REDUCTIONS

Senator QUAYLE. Thank you, Mr. Chairman.

David, first of all, I would just like to say from my own personal perspective and, I think, a number of other Senators share this, that you continue to be perhaps the most able and articulate spokesman for this administration in giving us a direction on where we want to go. I appreciate that and so do a number of others. There may be slightly tougher times ahead for us, but I want you to know that there are still a lot of us that are supporting very enthusiastically what you are trying to accomplish. I commend your ability.

My first question is this. Am I not correct in saying that the original budget reductions targets were not achieved by what the Congress actually did?

Mr. STOCKMAN. Yes; now, we get into a very complicated bookkeeping argument here because the CBO baseline from which the cut was measured is different from the administration baseline, from which we said we needed to save about $48 billion in 1982. But, even if you set that argument aside, two things need to be noted. One is the reconciliation bill was not comprehensive. Every dollar savings that we proposed was not addressed in reconciliation. The theory was that some of them would be addressed in the normal appropriations process and some of them would occur as the result of independent action, such as some of the user fees that were not in the reconciliation proposal.

Second, within reconciliation itself on the critical entitlement programs which will spend automatically unless reformed or changed, there was about a $2.8 billion shortfall in the outlay cuts for fiscal year 1982. That increases to nearly $12.5 billion over the next 3 years. That is primarily due to the failure to implement a workable medicaid cap. In addition, the Congress chose to provide less savings in the child nutrition program. The changes in the guaranteed student loan program were not as stringent as those we proposed. There were also a few other minor differences.

So, you can very clearly say that everything we needed to stay on track was not obtained. Add to that the increased momentum and increased upward pressure that has occurred from farm prices, interest rates, and other items. All these factors have driven up the budget far beyond the targets.

SPENDING REDUCTION GOALS

Senator QUAYLE. One of the reasons, not necessarily the major reason, that you are back here asking for further reduction or restraint in spending is that the initial try by the Congress simply did not achieve the goals that you had outlined. That is basically correct. If that is correct, there should not be all that much consternation and concern because we are now being asked for further budget reductions. We may talk about how deep they are going to be, but it certainly does not surprise me that you are back here in

September asking for budget reductions. As you said, I believe, that we would be off by about $20 billion according to your figures over the 3 years, 1982, 1983, and 1984.

Mr. STOCKMAN. Senator, let me just respond by saying this. I think it is probably naive to suggest that in one bill in 20 weeks you can correct a problem that has been building for 20 years. If you look at some of these overruns that now threaten the budget, to drive up outlays some $27 billion over where you put them at the first resolution, and drive the deficit beyond $60 billion and borrowing to $80 billion, those result from decisions made anytime over the last 20 years. We had less than a half-trillion-dollar debt when the 1970's started. We had a $1 trillion debt when they ended. A small change in interest rates on a debt that size quickly adds into outlays, as we were just discussing.

The farm bill increases are due to action taken by Congress in 1977, but we are still paying out those——

Senator QUAYLE. What I am trying to put to rest or at least put in perspective is the myth that has been created that the Congress gave this administration everything it asked for in the first budget reconciliation. That is not true. Is it or is it not?

Mr. STOCKMAN. It is absolutely untrue. We indicated even then that at minimum you would need $30 billion more in 1983 and $44 billion in 1984 and that, given this enormous momentum in the budget, there might even be additional threats that would have to be offset.

DEFER OR CHANGE TAX CUT FOR 1984

Senator QUAYLE. Thank you.

As far as fiscal year 1984, do you see that at some juncture—I certainly would not advocate it now personally—that we may have to get into discussing the tax cut in that year, that is, deferral or a change in the tax cut for fiscal year 1984 to meet the $100 billion savings that we have to come up with? Do you foresee that at some juncture, we will have to deal with amending substantively the tax bill that was enacted, or not?

Mr. STOCKMAN. I do not foresee that. And I think it might be a very serious mistake, right now, several days after the first budget year that the program has started, to say we have thrown in the towel already, we cannot cut back the size of this Government, we cannot shrink outlays by $42 billion in 1984 even though we have 2 or 3 years to do it. And, so, before the program even starts, in terms of reducing rates and providing incentives to the private sector of our economy, we are going to revert to the old form of balancing the budget on the taxpayer's back. That was tried for 5 or 6 years in the last part of the 1970's, and it did not work. There is no reason, I believe, that it would work again.

It seems to me we ought to make a much more strenuous effort to cut the spending suit before we start changing the revenue cloth.

REDUCE AMOUNT OF TREASURY BORROWING

Senator QUAYLE. I have one final quick question. Do you have any quick message for Wall Street?

Mr. **Stockman**. I do not believe that Wall Street listens to any messages from me or anyone else gathered in this room. What they do is measure outcomes. If, working together, we reduce the amount of Treasury borrowing in the next 6 or 9 months, and the prospects for the next 2 or 3 years, that is all the message that will be needed. Interest rates will come down, and financial confidence will revive.

Senator **Quayle**. Thank you.

Chairman **Domenici**. Thank you, Senator. Senator Metzenbaum?

INTEREST RATE PREDICTIONS

Senator **Metzenbaum**. Mr. Stockman, it is nice to see you back before us again.

I think that we might differ on issues, but I think we all would agree that Government needs to be credible. I think the concern that many of us have at the moment is that back in February you said that interest rates were going down to 8.5 percent, 9.5 percent. A day later, you said you had gone too far; I thought about that, and I think I misspoke a little; we do anticipate a substantial decline in interest rates, but I cannot say it will be down to 8.5 percent at an early time. You then have in the budget projections which you gave us dated September 10, 1981—not July, as you responded to Senator Exon—that they will be 10.5 percent. And today you say they will be 12.7 percent.

Now, the question I have is, How can the American people or Wall Street or we in the Congress or anybody really have much faith in your figures when they seem to be in a rather fluid state?

Mr. **Stockman**. Senator, I would suggest that, if the credibility of our entire fiscal and budget control program, ours and yours, depended on my capacity or your capacity to predict interest rates 10 months out or 1½ years out, then we would all be in big trouble. I do not think anybody can do that because we are going through unprecedented conditions of financial change.

Senator **Metzenbaum**. Why did you do it then?

Mr. **Stockman**. Why did I do it? Because I have to develop a budget. That budget has a whole variety of programs that are interest-rate sensitive in terms of their outlay level, to say nothing of the service on the national debt. So, we have to use a number. Clearly, the number that we used was inaccurate. It has been changed. We have accommodated to the facts of life that have occurred.

But I think I would also point out to you that we were roundly criticized for our inflation forecast in February during the same hearings that you mentioned. And now the consensus of forecasters is, and the empirical facts are, that our inflation forecast was basically correct. I think that we have been——

INTEREST FIGURES NOT CREDIBLE

Senator **Metzenbaum**. I do not want a speech, Mr. Stockman. I really would like to ask you some questions. Now, I asked you a question, and please give me an answer. I do not think that I want a whole speech. It is very difficult to question somebody who just goes on and on.

I have asked you why your figures are not credible, and you are telling me about your inflation figures. But I am asking you about the interest figures, which you specifically said would be 8.5 to 9.5 percent, and then you backed off a little bit. You came back to us with a 10.5-percent figure on September 10, 1981, which is not very long ago. And now you are saying that it will be 12.47 percent. Now, those are totally different figures.

I would say to you that, sure, nobody can predict way into the future. But the fact is your figures have changed since February 23, 1981, to October 7 or 8, whatever today is, by 4 points. That is quite a bit.

Chairman DOMENICI. Wait a minute. We want to establish some ground rules. The witness can answer the questions as he sees fit, Senator Metzenbaum. If you want to argue with him about——

Senator METZENBAUM. I do not want to argue with him, Mr. Chairman.

Chairman DOMENICI [continuing]. And if you think his answers are too long and thereby denied you an opportunity to inquire in your 5 minutes, the chair will accommodate and give you additional time.

ZERO IN ON SPECIAL TAX PRIVILEGES

Senator METZENBAUM. As long as the Chair will do that, the Senator will be very relaxed about it; but I am always worried about the bell ringing on me.

You talked about $13 billion, Mr. Stockman, in additional cuts. But, when Mr. Regan was here, he talked to us about some of the tax expenditures that you would be moving into. You could pick up $2 billion if you eliminated the intangible drilling cost writeoff. You could pick up $2 billion if you eliminated the State exemption of the windfall profits tax. You could pick up $1.9 billion if you eliminated the foreign tax credit for oil and gas. You could pick up $1 billion if you made banks treat their bad debt losses on their statements the way all other businesses do. You could pick up half a billion dollars if you targeted industrial revenue bonds so that they not be used for McDonald's and racquetball clubs and tennis clubs. You could pick up $12 billion if you would just undo the harm that was done in an effort to get the tax bill through by repealing the windfall profits tax on oil companies. That would be through 1986; $33 billion by 1990. And you could pick up $27 billion by 1986 if you eliminated the gimmick that was put into the last tax bill having to do with selling or leasing your losses to other companies. That would pick up $27 billion.

My question to you is this. I am not asking for tax increases; that was the answer you gave me at an earlier point. What I am asking you is this. Why not zero in on some of these areas where there are special tax privileges that certain people or certain corporations have as a benefit instead of again trying to cut back on aid to education or trying to cut back on food stamps or the programs that have to do with people? Why do you not move in those directions?

Mr. STOCKMAN. Senator, let me give two answers. One, I think that we have suggested we are going to examine many of those proposals that you mentioned. We have even explicitly said that, in the case of industrial development bonds, changes need to be made. We will propose, I assume the Congress will dispose, and there will be a rather strenuous and lively debate about the policy wisdom of any of those changes.

Senator METZENBAUM. When?

BALANCED BUDGET POSSIBILITIES EXAGGERATED

Mr. STOCKMAN. We expect to have our set of detailed legislative proposals to the Hill in a couple of weeks. It has to be done with some care. Some difficult judgments are involved. Legislative drafting is involved. But we will have it here at the earliest possible date. Secretary Regan is committed to do that.

The second point I would make is that a couple of your figures, I think, exaggerate the possibilities available. That is one of the reasons why I get a little nervous when someone says I can eliminate the deficit, $60 billion, or even half of it by closing tax loopholes. In the case of the oil provisions of the Tax Act of this summer, it is true that the revenue loss is $12.5 billion over the next 5 years from those provisions. But that is the revenue loss on the windfall profits tax. You have an offsetting revenue increase on the corporate tax and on the income tax. The net revenue change over 1982 to 1984 is only $4.1 billion.

You may want to reconsider that, but it is not a large piece of the problem over those 3 years.

Senator METZENBAUM. The CBO figures are where I got my figures from. I do not know where your figures are coming from, but mine come from——

Mr. STOCKMAN. Now, CBO's figures are right. That is the loss of windfall profits revenue. But then you have an offsetting increase as a result of that change in corporate tax collections and in individual tax payments because the windfall tax is an excise tax and it is a deduction from taxable income when it is levied. So, the point is that the net change in Federal revenues—and that is our bottom-line concern—is $4.1 billion over the 3 years.

Now, the final point I would make is that you say why do we not do it all or most of it on the revenue side rather than on the outlay side. And I guess that is just a matter of basic difference of judgment. I do not think the Government should spend 23 percent of GNP. That is what we are spending this year. I believe over a 3-year period of transition, we can shrink the responsibilities, the commitments of Government to roughly 19 percent of GNP and balance the budget, not by looking for ways to tax the economy more, one way or another, but by reducing the spending commitments.

Now, we have a disagreement about that because we have a different political philosophy. But that is what the congressional process ought to hammer out.

CLOSE TAX LOOPHOLES

Senator METZENBAUM. But is not there a difference between taxing more and eliminating some tax inequities that in some instances become tax inequities that certain people get special privileges because they had the right lobbyist at the right point?

Some of these provisions—you might not agree with all of them, but you yourself said as you were sitting there a few months ago, you said that you had raised the issue with respect to some of these issues in the White House and you had been turned down—or with the Treasury; and I do not remember which it was.

Therefore, that is not a difference between you and me on that because you had indicated that you yourself had concern about some of these special tax benefits.

Mr. STOCKMAN. Well, Senator, from that vantage point I think I agree with you. But I would not simply repeal these so-called loopholes, misplaced incentives or abuses. I would repeal them and lower rates on an offsetting basis on the corporate tax or some other tax. What I am saying is, in terms of the Government claim from the production of income in our economy, 19 percent is high enough.

I think what you would do is close those loopholes and keep the revenues and not make offsetting changes.

Senator METZENBAUM. I am not even saying what we ought to do. I just say the loopholes ought to be closed, and then we can make the other determination as to whether we save that out of the $13 billion in cuts you are talking about or whether we reduce taxes generally. I think that is on the other side of the page. But on this side of the page it seems to me this administration does have some obligation to do something about the loopholes that exist, particularly when you are being so rough and so tough on so many Americans who do not have an adequate lobby here to speak for them.

Mr. Chairman, I gather my time has expired. Will we have additional time?

Chairman DOMENICI. I hope so. I am going to try. The reason I am not going to give you additional time is because I have been keeping tab.

Senator Gorton?

$115 BILLION MUST BE SAVED BY 1984 TO BALANCE BUDGET

Senator GORTON. Mr. Stockman, to the best of your ability to estimate it, how many billions of dollars is it necessary for us to save in fiscal years 1982, 1983, and 1984 combined in order to balance the budget by 1984 and to take the steps necessary in 1982 and 1983 to reach that balanced budget, over and above what we have already accomplished through reconciliation and the tax cut?

Mr. STOCKMAN. That number would be $115 billion over the 3 years. But remember that, if you save dollars by changing entitlement in 1982, you automatically get that savings in 1983 and 1984. So, it is a bit misleading to add 3 years worth of savings together. It is often the same programs for 3 years running. But it is $115 billion. We have proposed an $80 billion plan of revenue changes, defense slowdown, discretionary programs, and entitlement reforms to close most of that gap.

Senator GORTON. I think that, in spite of the differences of opinion expressed here today and elsewhere, that you would find that, for all practical purposes, every member of this committee and almost all Members of Congress of both parties would share that goal. Obviously, the differences which have been expressed here are in the methods by which we reach that 1984 goal.

Is it true that during the course of the preparation of this budget that you recommended to the President reductions in the growth of defense expenditures in an amount somewhat greater than those which are a part of your budget now in, say, a range of $27 to $30 billion as opposed to the $13 billion over the 3 years which are part of the budget which you have submitted to us?

Mr. STOCKMAN. Senator, I try to be as candid with this committee as possible, but one thing that I cannot do is to convey in public the private advice that I give to the President. It would be impossible for him or me to function and for decisions to be made within the executive branch. Every member of the cabinet could come up here and convey his own wish list of what should or should not be done.

DECISION MADE BY PRESIDENT IS SOUND

I think that the decision made by the President is a sound one. Even though there was another example of what I earlier called newspaper chatter and intrigue that occurred during August on this defense matter, the differences that we had in mind were very minuscule compared to the size of the problem. If anybody thinks the deficit problem can be solved primarily by cutting defense, they are running a risk that I do not think has been thought through.

Senator GORTON. Simply from a statistical point of view, that is clearly correct. Assuming the accuracy of those news stories, only about 10 percent of the $115 billion to which you testified would be involved in that difference in any event. Nevertheless, I think that you will accept the proposition that there has been a great deal of strong expression of public opinion that the proposals which you have made are not balanced in the sense that they do not affect equally every element of our population.

If we were to determine to reach that $115 billion goal by considerably lower reductions in the so-called discretionary areas, though still significant reductions there, by a somewhat larger reduction in the rate of defense spending, by an attempt to deal with all entitlement programs including social security at the present time rather than by waiting another year and a half for what many have characterized as superfluous report on social security, the recommendations of which we can all determine now, and if we met some of the criticisms of the members on the other side of the table as to revenues by a deferral of some of the individual tax cuts and a number of the other tax cuts for periods of time of between 6 and 12 months, would that not be likely to have a better chance of being accepted by the general public? And would it not be likely to have the same positive impacts on the economy as a whole as would the program which you have outlined here?

Mr. STOCKMAN. Senator, I think I would respond to that by saying first that the President has invited a dialog. We believe strongly that our mix, our approach is the only practical and viable way to get the job done. But he did indicate that the problem is so urgent that he invites the Congress and particularly the Budget Committees to step forward and analyze this problem and the options and see what you come up with.

Second, in terms of whether it would be more acceptable to the Congress or the public, I think that is a matter for you to judge. That is a political judgment. I think the legislative branch is every bit as adept at that kind of judgment as anybody in the executive branch.

Third, I would suggest that, rather than get into a long detailed debate about the precise weighting of each of these factors, what we ought to do is recognize the time is short. The general course and allocation needs to be made now. We have got to get the legislative wheels turning toward a resolution that holds down the 1982 deficit and begins to close the gap in the out-years.

Senator GORTON. Mr. Stockman, I agree with that. I thank the Chairman.

Chairman DOMENICI. Thank you, Senator. Senator Riegle?

Senator RIEGLE. Let me first make a comment, and then I would like to pose a question.

TAKE KNIFE TO SACRED COWS

Many Senators on this committee believe we do need discipline and spending restraint and have acted accordingly. What I think is bothering some of us, and I know is bothering me, is the double standard in the application of the discipline. We have deep cuts or eliminations in the number of basic human need areas. Yet, we still have in the budget—and I think you know that yourself—a number of sacred cows wandering around, multibillion dollar items that we really need to take the knife to.

I see the double standard in a lot of things. The tobacco subsidies are one. The Clinch River breeder reactor is another. The Tennessee waterway is another and some of the Western water projects. I think some of the excessively large defense spending increase falls into that category. I do not know how we can cut into those items, or whether it is politically possible within the coalition that the administration has come to depend on for some of their key votes.

I would like to urge you to take the knife to the sacred cows in the budget and see to it that everybody takes the cold shower together. I think one of the worst things at the moment is that some people are taking a double, triple, and quadruple size sacrifice, and there are others that are getting off, basically, scot-free. I even include some of the giveaways in the tax bill. I think the oil and gas companies waltzed out of here with billions and billions of dollars that they do not need. In effect, the sacrifice that everybody needs to bear some of, they have succeeded in unloading on a lot of other people.

I have to believe that that troubles you. I want to believe that. I know it troubles me, and I think it troubles many people around here on both sides of the aisle.

So, my comment is I would urge you to be as aggressive as you can in taking the knife to the sacred cow areas of the budget, the ones that I think basically have not done their share.

My question is on interest rates.

Chairman DOMENICI. Senator, before you ask your question, might I ask this. I assume most Senators want to go to the briefing as close to 5 o'clock as possible. Is that a fair understanding? Well, I am going to proceed then. We will be a little late to the briefing, Senator Riegle. And then we will have Senator Moynihan. We will reconvene at about 5:30, if that is satisfactory with you. I will pass the word that you will be here so everyone will know they have some additional time.

I am not positive, because we have abbreviated the day, and it is nobody's fault. We put off the testimony from 2 to 3 o'clock at the leadership's request, and then we had a number of votes. We may have to, on a short time, have you back for an hour or so. But I will tell them that you will be here for another hour or so if they have additional questions. Is that satisfactory?

Mr. **Stockman**. That is fine, Mr. Chairman.

Senator **Riegle**. I assume that does not come out of my time.

Chairman **Domenici**. No; not at all.

Senator **Riegle**. Very good.

REDUCE THE DEFICIT AND INTEREST RATES WILL DROP

Interest rates are sky high, as you know and as everybody knows. There are a lot of people in town today, particularly people connected to the housing, industry who are here on an emergency basis. They are saying if the interest rates don't come down significantly in the next 90 days, many of them are going to be out of business. They are literally hanging on by their fingernails. The farmers are coming in and saying that. The small business people, the auto dealers, the auto companies, many others as well are saying that.

I understand from your comments you think that the interest rates are going to have to stay high for a while. My question is this. Is there anything the administration is prepared to do to get the interest rates down by a measurable amount over the next 90 days? Is there anything you are prepared to do? When people ask me whether or not something is likely to happen, do I have to report back to them that there is no likelihood of a change in policy in this area?

Mr. **Stockman**. Senator, I would like to suggest that the one effective and direct thing we can do is to reduce the deficit this year. Now, I do not know what any other options would be.

Senator **Riegle**. Let me give you a specific suggestion.

CERTAIN KEY SECTORS NEED HELP

In your discussions with the Federal Reserve Board and Chairman Volcker, would it be appropriate for you to be assured that the Federal Reserve will take action with respect to money growth targets and other steps that will provide more credit at a lower rate to these damaged sectors that are literally dying right before our eyes?

Would you be prepared to argue for that?

In other words, what I am afraid of is that you are letting certain key sectors of the country go down the drain at a time when they desperately need some kind of response. And what they are getting is a dose of philosophic purism that says eventually this plan will work. And what I hear them saying is they are not going to be around by the time the cure takes effect.

I think you have an obligation to ask for some kind of an emergency response to that part of the problem and not just close your eyes to it.

Mr. STOCKMAN. Senator, I do not think that we are closing our eyes to it, but I again ask for a specific suggestion. If you refer to credit allocation, I do not——

Senator RIEGLE. Are not high interest rates——

Mr. STOCKMAN. Are you referring to credit allocation?

Senator RIEGLE. We are getting that today. We have got credit allocation by price. Today the people who get the credit are the people who can afford to pay the sky-high rates. The others are not getting it.

Mr. STOCKMAN. The administrative——

Senator RIEGLE. So, you have credit allocation at the moment.

ADMINISTRATIVE CREDIT ALLOCATION WOULD NOT WORK

Mr. STOCKMAN. Well, that is right. But administrative credit allocation, where we would determine one way or another the credit that would be allocated to housing or car dealers and not to somebody else, is one approach. I do not think it would work. I think it would cause a shamble in the financial market and make everybody worse off. But, if that is what you are recommending, then the answer is no.

Senator RIEGLE. I am not prepared to rule that out, but what I hear you saying is that you have no policy options. There is nothing that can be said to the Federal Reserve, nothing that can be done. We have to just take the high interest rates——

Mr. STOCKMAN. No; I disagree. I do not think the problem is——

Senator RIEGLE. What can we do in the next 90 days on interest rates?

Mr. STOCKMAN. In the next 90 days it is our expectation that interest rates will begin coming down due to softening of the economy, and some relief will be granted. But, to address the basic problem, there is one cause and one solution. It is not the Fed's fault. It is not the fault of lack of credit allocation. It is the fault of the enormous Federal presence in the credit market both for direct deficit borrowing and for all this loan guarantee activity in addition. This year we are borrowing, Senator, 50 percent of all the money available for lending.

Senator RIEGLE. Why are you not taking the knife to the sacred cows? Why are you not aggressive about all the exemptions in this budget cutting?

Mr. STOCKMAN. I think we will go after every sacred cow that can be identified.

Senator RIEGLE. My time is up.

Chairman DOMENICI. I just want to comment. I think that 12 percent across the board is taking on an awful lot of sacred cows.

Senator RIEGLE. Pete, that is a lot of baloney and you know it because we are not starting from the same base. We have already eliminated some programs. There are other programs that have made no sacrifices at all. So, do not pretend that it is even; it is not even. It is very uneven and you know it.

TWELVE PERCENT ACROSS THE BOARD NOT THE WAY

Chairman **Domenici**. Let me tell you, I am agreeing with you. Don't get made at me. I do not think we ought to do the 12 percent across the board because I do not think it is very evenhanded.

Senator **Riegle**. I am sorry. I misunderstood.

Chairman **Domenici**. I think we have to find a different way. But I do not think it is very helpful to imply that this man, who comes up here with what many think are draconian cuts, does not want to cut things. I think most people are talking about him cutting too much.

Senator **Riegle**. Well, there are many things they do not want to cut and you know that. They are wondering all over the budget, the sacred cows, and it is time to get after those. But there is also a time to do something on interest rates on an emergency basis in the depressed areas, and that is now. What I hear is that nothing is going to be done about it.

Chairman **Domenici**. Senator Moynihan?

Senator **Moynihan**. Thank you, Mr. Chairman. There is a vote on, and I am sensitive about time.

I would just like to press the distinguished witness a little bit further on this question of social security. In this morning's Wall Street Journal, Walter Heller observes that Mr. Reagan has "backtracked gracefully" on social security. He has proposed a Commission to report by January 1983. I volunteered to serve on it if anybody wants me to.

But then within days of the President's speech, you, sir, arrived at the House Budget Committee and testified not contrary to what the President said but with a view that we had not expected in that——

Mr. **Stockman**. Senator, can I save some of your time for other questions? The story is unrelated to anything I possibly or conceivably said during that hearing.

Senator **Moynihan**. Are "Basic Social Security Benefits Fair Prey for Future Budget Cuts"——

Mr. **Stockman**. The story is absolutely 180° wrong. It has happened to all of us before, as I am sure you are aware.

DEFINITION OF EARNED RETIREMENT BENEFITS

Senator **Moynihan**. Let us just try to walk through this. What you did say is that most of the President's proposed cuts in benefits from social security—and now let me quote you—"relate not to earned retirement benefits but primarily to disability, to early retirement, and to multiple benefits received for dependents." Then you spoke about people who entered the work force in 1940 will start retiring pretty soon, and because of double indexing will receive a "windfall" benefit.

What I wanted to ask you is your view of earned benefits, earned retirement benefits. How do you define them?

Mr. **Stockman**. Well, let me answer that by saying that an earned retirement benefit is a benefit derived from the primary insurance amount which is calculated from the average index of monthly earnings derived from the payroll record of the individual involved during a long period of time. That is the core of the system.

Now, over the years, we have grafted on some elaborations to that. The minimum benefit was one. That would not be an earned benefit, in my judgment.

Early retirement derives from earnings but it was added late in the system. The benefit level provided started in 1962. So——

Senator MOYNIHAN. You would not regard early retirement as an earned benefit?

Mr. STOCKMAN. It is an earned benefit, but it is not a core benefit in the sense that it was originally in the system, and——

Senator MOYNIHAN. Well now, is it an earned benefit or is it not?

Mr. STOCKMAN. I suppose you can say it is earned.

Senator MOYNIHAN. So you are not after early retirement anymore?

Mr. STOCKMAN. It is not a matter of being after early retirement anymore. The President clearly indicated that he wants to set that issue aside. Wait for your Commission——

Senator MOYNIHAN. You do not confine "earned benefit" to refer to withdrawals from the system not exceeding the individual's contributions to it?

Mr. STOCKMAN. No, no.

Senator MOYNIHAN. You refer to it as whatever the law provides.

Mr. STOCKMAN. That is right.

Senator MOYNIHAN. Is disability insurance an earned benefit?

Mr. STOCKMAN. Yes; because disability insurance is part of the system. But I do not know that we can establish any hard and clear line on any of these because the benefit conditions, eligibilities and amounts change constantly. They are in flux over time as this system elaborates.

SOCIAL INSURANCE SYSTEM AND PENSION SYSTEM CONCEPTS ARE DIFFERENT

Senator MOYNIHAN. I just wanted to make this point clear enough to you. By introducing the terminology of earned, earned, earned, it seems to me you are beginning to distinguish between a social insurance system, which social security is, and a pension system, which is a different concept altogether. Would you grant the concepts are different?

Mr. STOCKMAN. Yes; I would grant that. And I would also grant that we could get into a quite lengthy philosophical debate as to the proper weighting between replacement type pension benefits in the system and social insurance type adequacy benefits that were also intended for the system. There has never been a clear or distinct conceptual design for that. It is something that has evolved and changed, and views and opinions have shifted over time on it. And there will never be an explicit answer.

Senator MOYNIHAN. As long as you agree there never will be an explicit answer, we can leave friends. But watch that emphasis on earned. It implies that people who are beneficiaries of insurance for events which, if they were lucky, never would have happened, are somehow undeserving of the benefits they receive. Nobody is lucky who receives disability benefits, right?

Mr. STOCKMAN. That is correct.

Senator **Moynihan**. And no child on AFDC has really had all the good fortune that a child might expect. Social insurance protects you against events which you hope do not happen. We can agree on that?

Mr. **Stockman**. I think we can agree on that. And I think we can also agree that in every social insurance system there is the element of moral hazard, which I believe you have written on from time to time, and recognize it is something for the legislative body to be ever vigilant about.

Senator **Moynihan**. The moral hazard of receiving something from the U.S. Government that you have not earned. Terrible. Mr. Chairman, with that alarming thought that even you or I might benefit, I think we better go and vote.

Chairman **Domenici**. You go vote. I have a couple of questions. Thank you, Senator.

ESTABLISH SIGNIFICANT CREDIBILITY EARLY

Let me just ask if you could give the committee the benefit of your thoughts on this. First, to the extent that you have said that a significant, like $16 billion cut in the 1982 deficit is very, very important to the success of the economic recovery, I disagree. I am firmly convinced that the success is far more long term than that. I believe we must establish a significant credibility early on the out-year cuts that are yet unaccomplished, for whatever reason.

But let us assume we must make significant 1982 cuts. What would you tell us your opinion is as to how many of the out-year cuts we have to put in place before this year is up, choosing that as a parameter, to add that dimension of management of the deficit that appears to be the most lacking portion of the economic recovery package?

Mr. **Stockman**. Mr. Chairman, in our package the $16 billion first year effect has been highlighted and dramatized by the press, but it was actually an $80 billion 3-year package. And the intention was that most of the policy measures, $28 billion worth of entitlement changes, $22 billion worth of revenue enhancement, $13 billion worth of defense change, and the current and future year effect of the 12-percent across-the-board cut in this year's appropriation would all be put in place at once this fall. So, we would have carved out and charted the way for closing most of the out-year budget gap that exists.

Chairman **Domenici**. Thank you very much.

We will reconvene. Let us make it at the call of the Chair but no later than 6 o'clock.

[Whereupon, at 5:09 p.m., the committee was recessed.]

VIEWS OF THE REAGAN ADMINISTRATION

THURSDAY, OCTOBER 15, 1981

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 10:21 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici, chairman of the committee, presiding.

Present: Senators Domenici, Armstrong, Grassley, Quayle, Hollings, Chiles, Johnston, Sasser, Metzenbaum, Moynihan, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

Chairman Domenici. The hearing will come to order.

This hearing was called to accommodate Senators that felt we did not have enough time for questions and answers, Mr. Stockman, during your appearance here on October 6. I am sorry for the delay this morning, but we were tied up going to the floor and returning.

What I am going to do is yield now to Senator Sasser, and then we will go to Senator Metzenbaum, and as Senators arrive, we will give them as much time as they need.

Senator Metzenbaum. Mr. Chairman, are any motions in order? Jim and I would like to offer some motions when we have a majority of two to one. [Laughter.]

Chairman Domenici. Well, you could move them but——

Senator Metzenbaum. I just lost. [Laughter.]

Chairman Domenici. Whether we vote or not will be another issue.

All right, Senator Sasser.

SOCIAL SAFETY NET

Senator Sasser. Thank you, Mr. Chairman.

Mr. Stockman, you have a number of times talked about the so-called social safety net or safety net, and there has been a lot of conversation about that in this administration. Many of us are beginning to think that this safety net is beginning to have some holes in it.

But the preservation policies under the administration were guaranteed, and with this in mind $35 billion was squeezed out of the Federal budget during the reconciliation process. Now, I personally had some serious reservations about many of these cuts, but nevertheless went along with it, voted for it here in the Budget Committee, and felt that the President's program really ought to be given a chance to work, because that is what my constituents, frankly, were telling me.

But in light of the present budget reduction proposals, could you please explain how much of the safety net has now been exposed to the budget-cutting act, or whether, in fact, the notion of a safety net is really now being disregarded altogether?

Mr. **Stockman**. Senator, let me answer that question this way. The safety net is a concept or a notion that we should protect people who need assistance—cash, housing, food, medical, or other. It is not intended that a program be labeled as part of the safety net and therefore is permanently immune from any kind of reform or tightening or retargeting that might be needed in order to cut the cost while at the same time preserving benefits for those who need them.

You could argue, for instance, that the student loan program is part of the social safety net insofar as it permits lower income and middle-income students the opportunity for higher education. But when that law makes eligible families with annual incomes $100,000 or $120,000, I do not think changing that law in order to eliminate their eligibility and save costs is any violation of the social safety net.

Another example is the school lunch program. Obviously, providing nutritious meals for low-income children at a subsidized rate is part of the notion of the social safety net. But we suggested that families with annual income above $15,000 a year, ought to pay for their own children's lunches. To reform that program in order to eliminate eligibility for higher-income families is not a violation of the social safety net.

So, it seems to me you need a very careful analysis of every one of these entitlement programs, and the distinguishing criteria is whether it protects those who are truly needy versus those who should provide for themselves.

INTEREST RATES

Senator **Sasser**. Mr. Stockman, earlier this year during the confirmation process, you came before the Governmental Affairs Committee and you and I had a conversation at that time about the problem of interest rates.

My position then and my position now is that we are never going to have a significant economic recovery in this country and in this economy until we can do something about the high interest rates.

Now, during our conversation earlier before the Governmental Affairs Committee, you indicated that if we had the right kind of policies and the right kind of economic policies were adopted by this Government, this would tell the market that we mean to control inflation and that both long-term interest rates and short-term interest rates would come down.

Well, now, we have adopted that program. We have adopted a tax cut that the administration has proposed which some say will cost us $750 billion in lost revenues over the next 3 to 4 years. We have adopted a program of budget cuts so far which I am told will aggregate over the same period to something in the neighborhood of $130 to $150 billion.

But you are before this committee today, I understand, asking for further budget reductions, and you imply in your testimony that Congress has not been cooperative in providing the reductions which were originally sought by the administration.

Well, we did go along with what the administration proposed. The administration did get its program through, but we see interest rates, rather than turning around dramatically, go up. We have had a short-term drop in the last day or two, but the fact that interest rates are not coming down significantly—does this not indicate to you that serious miscalculations have been made by the administration as far as the acceptance of the program by the financial interests in this country?

SOME ORIGINAL SAVINGS NOT ACHIEVED

Mr. STOCKMAN. No, I do not think that would be the case, Senator. You did not adopt the entire program in the legislative measures this summer; you adopted the first installment on the budget side, in particular. We indicated from the very beginning that even if all the cuts we proposed in March were achieved, $75 billion in additional savings required would still be in budget years 1983 and 1984.

But now we find ourselves in a circumstance where many of the savings assumed in the original plan this spring have either not been achieved or have been rejected by the Congress for one reason or another. About $14 billion in entitlement savings that we assumed last March for medicaid, guaranteed student loans, and school lunches were not achieved in the reconciliation bill for the 1982-1984 budget period.

About $20 billion in savings we assumed as a result of the effort to reform and achieve solvency in social security have now been set aside because of the unwillingness, particularly of some Members in the House, to act.

Beyond that, we find that there is enormous momentum remaining in the budget as a result of decisions made in the past. The bills for these decisions are coming due today, whether it is the farm programs, whether it is higher interest rates on a $1 trillion debt, or higher participation and benefit rates even for some of the programs that we reformed the first time.

Medicare is up $800 million from what we, the Congressional Budget Office, and your staff projected last spring. Food stamps, despite major changes in eligibility, are now up in 1982 by $700 million to over $1 billion.

In other words, the first installment stunned this enormous unsustainable growth of Federal spending, but there is still a lot more to do. That is why I am here today, and it would be a mistake to conclude that one budget reconciliation bill solved the problem for all time.

Senator SASSER. Well, Mr. Stockman, are we just going to come back here time after time after time and come with more and more and more cuts?

My understanding was that if we did the cutting in the first go-around and if we passed the President's tax package, we would be well on our way to an economic recovery and we could let up on this continued cutting. I think that was the understanding of most members of this committee.

Mr. **Stockman**. I do not believe so, Senator. In your first budget resolution for 1982, you listed about $45 billion that you, as one of those who voted for it, would commit yourself to save out of the 1984 budget. Some of that was thought to be in the indexed programs, others in the discretionary programs, some of it through what we have been calling fraud, waste, and abuse. You committed to that.

We are now all here searching for the appropriate ways and means and balance to achieve those savings that you voted for a couple of months ago.

Senator **Sasser**. No further questions, Mr. Chairman. Thank you, Mr. Stockman.

Chairman **Domenici**. Thank you, Senator Sasser.

You mentioned 1984 and $45 billion unidentified cuts yet to be made. You failed to mention that there was a significant number in 1983 that was in that resolution. That was $30 billion, was it not?

Mr. **Stockman**. That is correct, Mr. Chairman.

Chairman **Domenici**. $30 billion?

Mr. **Stockman**. That is correct.

Chairman **Domenici**. If the Senators on the majority side do not mind, I would like to let Senator Metzenbaum go next. He has been very patient and waited, and I know he has some very exciting questions this morning. [Laughter.]

Senator **Metzenbaum**. Well, I want to get away; the President wanted me down to talk about AWAC's later, so I want to get away for that.

Chairman **Domenici**. All right. We are delighted; if you are going there with an open mind, we will let you talk all morning. [Laughter.]

TAX EXPENDITURES

Senator **Metzenbaum**. Well, I am not going there, Mr. Chairman; I am only pulling your leg a little bit.

Mr. Stockman, you know that you and I have talked previously, and I have talked with Secretary of the Treasury Regan about the fact that all of the emphasis of this Administration has been on the question of budget cuts. And as a former business person and as somebody who understands that the budget has to do with what comes in and what goes out, I bave been attempting to get the Administration to examine the whole question of tax expenditures.

In all fairness to you, you have indicated publicly that you are not really challenging that effort. But the fact is that although you are not challenging it, that is not the Administration's policy, and we are faced with $13 billion in additional budget cuts that are suggested when there are literally almost unlimited numbers of billions available in the area of tax expenditures. Now, when I say "almost unlimited," I think that is an overstatement, but actually it depends upon how far you would be prepared to go, and I would not be prepared to go beyond eliminating some of those that are abusive.

When Mr. Regan was here, he told us that you could eliminate tax shelters by the new tax rates, and there was just really going to be euphoria; that nobody would seek tax shelters in the future because the new tax law was going to reduce their tax rates.

NEW TAX LAW GIVES SHELTER BUSINESS HEFTY BOOSTER SHOT

Now, Business Week, on October 19, reports a surge in tax shelter sales, new breaks for investors; "oil, gas, and realty win favor under the 1981 law." It goes on to state as follows: "Far from snuffing out the tax shelter industry as many had expected, the new tax law, if anything, gives the shelter business a hefty booster shot." Then it goes on to say that oil and gas deals, and especially real estate deals, come out far ahead of other types of shelters. It talks about the fact that E. F. Hutton & Co. will increase their shelter placements to $1 billion this coming year.

We find that this administration, which has not hesitated to talk about it–Mr. Regan actually said, "We need a little time; do not push us; we will come back." Now, the President's new program of $13 billion talks about $3 billion in some tax loopholes, but that is all.

I know that you are very familiar with it, because in your testimony previously before this Committee on April 1, I said, "You did recommend that these tax expenditures be eliminated in order to balance the budget, did you not?" And you responded, "Not in order to balance the budget." And then I said, "You sent over a book of them to Mr. Regan, the Secretary of the Treasury, and you were turned down, were you not?"

OBSOLETE, INEFFICIENT, OR UNJUSTIFIABLE TAX EXPENDITURES

You then said that you did not send them over as a way of balancing the budget, but then went on to say, "I think there are some tax expenditures that are obsolete, inefficient or unjustifiable. They ought to be eliminated as a matter of good tax policy and as a matter of political equity in some general sense—basically, the sense that you are trying to articulate here today. It might not be a bad idea to look at them later on."

Now, the "later on" is here; nothing is happening. The inequities are growing; there is an element of tremendous unfairness. And without zeroing in on whether it is the food stamp issue or the milk program or the school lunch program or the WIC program or the aid to schools or the revenue cuts, or on ad infinitum, is it not time for this administration to try to introduce some element of equity—the very word you used—into the whole tax structure, and do you see anything forthcoming in the immediate future to do something about that other than the talk about the $3 billion?

TAX EXPENDITURES ARE BEING ELIMINATED OR MODIFIED

Mr. STOCKMAN. Yes, Senator, I think it is time, and I would like to point out and clarify that $3 billion is only for 1982. The dollar figure is low because we assume it takes about 6 months to get something through the legislative process, and we are closing loopholes, eliminating tax expenditures, or modifying them. You have to write regulations, transition rules, and so forth.

So, the $3 billion is just the first-year cash flow savings. But I would suggest to you that a better measure of what we have proposed is the $11 billion target for 1984, and $21 billion over the next 3 years. We feel that there are enough obsolete so-called incentives, tax expenditures, abuses, and so forth, that at a minimum we should target for those amounts. Perhaps the Congress and even we ourselves will have more ideas as we get into this debate.

Now, we are going to propose detailed legislative language within the next couple of weeks.

SHELTER INDUSTRY STIMULATED BY ADD-ONS

Second point: On the article that you cite, I must defend the administration and the Secretary of the Treasury here because the tax legislation that we sent to you in February had no shelters or new loopholes in it. It was a straight cut in the rates for individuals only, and a reform of the depreciation system to take account of the kind of inflationary environment we live in today.

Now, what is stimulating the shelter industry is all the add-ons that were included by the Senate Finance Committee or the House Ways and Means Committee or various Members of the Congress. We had to go along with those as part of the compromise of the legislative process to get a bill, but let us at least get the record straight that they were not our proposals. They were proposals that were volunteered—in fact, insisted upon—in the legislative process on Capitol Hill.

ALL TAXES NOT CREATED EQUAL

The third point: I agree with you that all taxes are not created equal. It seems to me that what we want to do is cut taxes on capital, on income, and on business and entrepreneurial activity that will expand the economic base of the economy.

For those areas where you are taxing consumption or where you have abuses, and inefficient or obsolete tax subsidies and expenditures, you want to take a hard look at whether or not those should be eliminated. The revenues available could help contribute to this problem of closing the budget gap that we face today.

THREATENED VETO OF APPROPRIATIONS BILL

Senator **Metzenbaum**. Mr. Stockman, when the House recently took a position with respect to some of the programs in the appropriations bill, the President said, "If you send me an appropriations bill that goes beyond these limits"—and I forget the amount. What was the excess involved; $60 to $80 million, was it?

Mr. **Stockman**. It was the HUD appropriation bill that exceeded our request by $620 million that inspired the President's statement.

Senator **Metzenbaum**. $680 million, and the President threatened to veto that bill on that basis. The tax bill which contained all these loopholes, amounting in one instance alone—the question of the safe harbor leasing provisions in the 1981 tax bill, was that part of the Reagan program or was that a congressional initiative?

Mr. **Stockman**. Congressional.

Senator **Metzenbaum**. That one alone will cost, according to published reports, between $26 and $30 billion in the 6-year period, and yet the President did not threaten to veto the bill if that were in it.

Mr. STOCKMAN. Senator, I appreciate your line of questioning, but as a practical fact of life, if we do not change the tax code through a new piece of legislation that springs from the Hill, the old one stays in place, and we think it is terribly damaging to the economy.

An appropriations bill, by contrast, does not get spent unless it is signed. There is a great deal of leverage with a veto on an appropriations bill, and no leverage at all on a tax bill that requires action by Congress. If you veto a tax bill, you are back to the status quo. That is the difference.

ADMINISTRATION OBJECTS TO SOME TAX LOOPHOLES

Senator METZENBAUM. Can you tell me any single instance in which the administration made known to Congress its objection to some of the new loopholes or some of the old loopholes that were not covered in this tax bill?

Mr. STOCKMAN. Yes; they are numerous. During the whole markup process in the House and the Senate, on a lot of features that would not be useful, or would be academic, to discuss today, I think the record is pretty clear. We resisted many of these, but they were the legislative price for the more important tax policy changes that we were seeking to achieve.

Senator METZENBAUM. Did not the President or you or someone else on his behalf agree to an additional $26 billion in cuts and the windfall profits tax on the oil companies over and above the $20 billion that was already in the bill as it came out of the Senate Finance Committee?

Mr. STOCKMAN. Well, obviously, when you sign a bill, you take accountability for it. I will not argue with you, but we did not propose those; they emerged.

Senator METZENBAUM. I think you did; I think that the President agreed to those amendments, the $26 billion on the House side—and I am not saying he personally, but at least with some of his people—as the price of picking up some votes in order to get the tax bill through. That is what I find so difficult to understand with an administration that ostensibly wants to be fair.

Mr. STOCKMAN. Well, Senator, I was a member of this body just like you. There were times when something that I felt was important to get done could only get done by attaching it as a rider to another bill. I am sure that you have had occasion, once or twice, to participate in that experience, and I think that is what we are describing here.

It would not do us any good in solving the real problems facing us to discuss the legislative process and its dilemmas indefinitely.

Senator METZENBAUM. There are other members. I will wait for my next turn, Mr. Chairman.

ENTITLEMENT REFORM PACKAGE

Chairman DOMENICI. All right. Thank you, Senator.

Mr. Stockman, I did not ask any questions at the outset; I have just a couple.

Timewise, when will the administration be ready to discuss in detail the entitlement reform package which contemplates to save $3 billion in 1982, and then, as I understand it, it would have automatic savings of $10 and $15 billion, respectively, in the out years?

Mr. STOCKMAN. Mr. Chairman, the work of the technical task force that was put together from the various agencies involved is now complete. That work will be reviewed by the President very shortly, and as soon as that review is completed and final decisions are made, it will be sent to the Hill and we can have a detailed discussion with you. I am talking about a matter of days.

Chairman DOMENICI. With reference to the revenue enhancement package, do you have any idea as to when that will be available?

Mr. STOCKMAN. Well, I would suggest roughly the same time frame and the same state of development. The technical work is done. Now, the policy decisions have to be reviewed and finally determined.

CONTINUING RESOLUTION

Chairman DOMENICI. It is my understanding—and if I am wrong, correct me—that you proposed or will propose a series of deferral messages with reference to 1982. I do not quite understand what that is and what they are.

Am I correct that you intend to do that, and if so, could you briefly explain that?

Mr. STOCKMAN. Well, Mr. Chairman, I think the quickest explanation would be that this is a very complex continuing resolution. On an account-by-account basis, we made a test of whether spending would run at the 1981 rate or at a rate that was provided in a bill passed by a committee or the whole House or Senate.

What we found as we analyzed the bill was that in a limited number of accounts, the funding rates in the bill are way above what had been requested by the President in September. Therefore, rather than permit the agencies to obligate at those very high rates on a selective basis—because it is haphazard and random as to how this continuing resolution applies on a line item basis—what we have done is to apportion for 51 days an amount of money for each account equal to 14 percent of the September request. In some cases the continuing resolution provides more.

What we have proposed, after a discussion with the chairman of the Senate Appropriations Committee and others, is to defer that difference for only 51 days, the life of the continuing resolution. We did this in order to preserve the option of Congress to consider our September request, and to allow ourselves to press the case and get a decent hearing on what we think is necessary to hold the budget down. It is fully in accord with the Budget Control and Accounting Act of 1974.

TWELVE PERCENT REDUCTION ACROSS THE BOARD

Chairman DOMENICI. Mr. Stockman, is that level that you are attempting to pro rate down to the level suggested in the last Presidential address?

Mr. STOCKMAN. That is correct, Mr. Chairman.

Chairman DOMENICI. So, the accounts are correct that you would attempt to bring that continuing down to the 12-percent reduction across the board recommended by the President?

Mr. STOCKMAN. Yes; but I want to be a little more careful and point out that the continuing resolution actually provides in many, many instances a funding level that is more than 12 percent below the President's request. I have a list of those programs here that I could submit to the Committee.

Chairman DOMENICI. Yes.

Mr. STOCKMAN. In other cases, the continuing resolution provides funding levels well above the September and even the March request.

Now, in that latter set of instances, you are talking about, we calculate, $13 billion in budget authority for a selected set of programs—$13 billion in excess of the September level. If we were to obligate on that basis for a full year, you would add over $7 billion to outlays in 1982, and it is that part of the continuing resolution that we are trying to hold down.

In other areas, Congress, through this complicated continuing resolution, has actually funded programs at levels below the September request.

Chairman DOMENICI. Yes.

Mr. STOCKMAN. And we cannot, obviously, obligate above that level because we are bound by the ceiling in the continuing resolution.

SEPTEMBER OUTLAY REDUCTION PACKAGE

Chairman DOMENICI. My last question, Mr. Stockman, is at our last meeting, I asked you if it was your intention and the President's intention that the September 24 outlay reduction package—was it your intent and the President's that that size of package, with its outyear effects on curtailment, be considered this year? Is that the reason it was proposed?

Mr. STOCKMAN. That is correct, Mr. Chairman.

Chairman DOMENICI. Why?

Mr. STOCKMAN. Two reasons; one, the 1982 budget is experiencing enormous overruns and we must avoid the experience of the last 2 years where, for good reasons and bad, we missed our targets by $50 billion.

Second, the lag between making a policy decision enacting a budget reconciliation bill and actually implementing the reforms is so great—from 1 to 3 years—that if we are to have any hope of bringing the outlays down in 1983 and 1984 that we now project and you project, it would be wise to get started now.

In my formal testimony, I presented the case of those five entitlements that we thought we were saving about $6 billion on in the reconciliation bill. We may end up saving nothing in 1982 due to transition problems, due to delay in writing the regulations, and due to erosion during the legislative process consideration.

So, for those two reasons—the immediate 1982 overruns and these enormous lags in getting at outlays in 1983 and 1984—we believe that this structural problem that we now confront in terms of tailoring the spending level to the revenues that we have available should be addressed in a major way yet this fall.

Chairman DOMENICI. Senator Johnston.

ECONOMIC ASSUMPTIONS

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Stockman, I guess in the early spring you were here before this committee asking us to sign onto the program of budget cuts and tax cuts. Most of us bought that and did sign on. But in connection with that testimony, I asked you whether this terrible, horrible, wrenching budget-cutting was going to be an annual exercise, and you, in effect, said that we would be most of the way home with last year and you did not expect a repetition of that difficulty.

Well, here we are this year with a further request for $13 billion in cuts. I read by the morning paper that the leadership on the Republican side probably will not deliver on the $13 billion because it is so extraordinarily difficult to cut after you have already sliced away the fat and cut into the bone and the muscle.

But I am deeply distressed when I think of the difficulty of cutting that $13 billion and how far we have to go and how increasingly clear it is that all the assumptions on which this whole budget is based are wrong.

I would like to be reassured; I would like to find out what the game plan is. As I read your testimony, according to your testimony we are still relying on these, what I consider to be unrealistic, economic assumptions: 5 percent growth in 1983, and a 7.5-percent 91-day bill rate for 1983. Are we still relying on those assumptions?

Mr. STOCKMAN. Not for 1983; those are 1984 numbers that I believe you have cited.

Senator JOHNSTON. All right. We are still using those numbers, though. CBO, for example, says 11.4 percent for the 91-day bill rate, and you are 7.5 percent.

Mr. STOCKMAN. No, Senator. For fiscal year 1982, our budget now assumes a 12.5-percent T-bill rate during calendar 1982. We would then expect, if additional budget reductions are made and the deficit gap is closed, that out in calendar 1983 and calendar 1984, the interest rates would come down to the level we have targeted.

Senator JOHNSTON. Well, you have not changed for 1983, have you? At least the CBO is reporting that you project a 7.5-percent 3-month Treasury bill rate for 1983.

Mr. STOCKMAN. Well, for fiscal year 1983—and I think the fiscal year is the appropriate measure because the T-bill rate drives the outlays in the year—we are targeting 8.0 percent. On a calendar year 1983 basis, it is the 7.5 percent that you have cited.

BALANCED BUDGET BY 1984 WILL REQUIRE ADDED TAXES

Senator JOHNSTON. Right. There is a four-point difference there. You have still got a GNP growth rate, according to this CBO publication, of 5 percent in 1983. I will not argue that because that has been argued here many times. Suffice it to say that many of us think the projections are too rosy.

But even using those rosy projections, according to your testimony, as I read it, in order to get a balanced budget by fiscal year 1984 we have to either add taxes to the tune of $114.8 billion—is that correct?

Mr. STOCKMAN. Senator, that is over a 3-year period.

Senator JOHNSTON. I understand.

Mr. STOCKMAN. And you run into a problem when you add the same savings together 3 years in a row. In other words, you might make a policy change to tighten food stamps by $1 billion in 1982; you save $1 billion in 1983 and $1 billion in 1984. So, when you add the annual savings together, you get a misleading concept.

What you must look at is the reduction from what would otherwise result in the current policy base. In my testimony, I said it would be a $60 billion reduction in 1984 from what would otherwise be spent if Congress took no policy action between now and then.

Now, in your first concurrent resolution, you programed $45 billion worth of savings. That was part of the plan adopted by this committee; that in future exercises, budget resolutions, reconciliation, and other legislative action, the $45 billion reduction would be achieved. We are $16 billion over that now on a policy basis, setting aside the economic assumptions, primarily for two reasons. There is a $6.5 billion shortfall in reconciliation. We did not get a medicaid cap, and our proposed change on guaranteed student loans and other programs. Second, the social security withdrawal adds about $9.6 billion.

NEW SAVINGS PROPOSALS

Senator JOHNSTON. Well, let me just ask about this. Looking at your table 8, "New Savings Proposal,"[1] we have got a 12-percent, across-the-board fiscal year 1982 cut; that gives you an $8.4 billion savings in 1982. Now, are you saying that the $5.3 billion for 1983 is included in that $8.4 billion, or do we not also have to take some additional action?

Mr. STOCKMAN. No; you would not have to take any additional action in the case of that line. Here, you are dealing with discretionary programs that are appropriated on an annual basis. We have called for a $17.5 billion budget authority cut in 1982; that represents the 12 percent reduction.

However, it takes us 3 years to get the outlay savings, since these programs spend so slowly. So, in other words, if you made the 12 percent cut this year, you would automatically achieve a $5.3 billion outlay savings from the current budget base in 1983, and $3.8 billion in 1984. That is the outlay tail; you do not have to cut the program again. You could restore every one of those programs back up 12 percent next year. Now, that would get you in trouble in some other ways, but those savings would still occur. That is the outlay stream from a one-time policy action.

UNIDENTIFIED SAVINGS

Senator JOHNSTON. All right. Now, on your future savings to be identified, you have got $11.7 billion and $23 billion for fiscal year

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[1] See p. 222.

1983 and 1984. How about those? Is that a one-time cut for which you get a double bonus?

Mr. STOCKMAN. Well, it depends on where you take them. If you take them in slow-spend programs, if you cut $11 billion in outlays in 1983, you would probably get most of the remainder in 1984. But that would have to be new policy action beyond anything that we have on the table at the present time—the 12-percent discretionary cut and entitlement and revenue package.

In other words, of the whole $115 billion problem that you have identified, the package pending before the Congress—the entitlement package, the revenue package, the defense slowdown, and the 1982 budget authority cut—will provide $80 billion of it. What you have then remaining on this 3-year problem is what we have called here the unidentified savings.

Senator JOHNSTON. Well, I look at your cuts, and it is $114.8 billion, really, no matter how you double it up. It is still difficult to cut 12 percent and hold it at that when these cuts are difficult and inflation is continuing and needs are continuing.

But then I look at the difference between your $114.8 billion and CBO's, and CBO's is $178 billion. And then I look at the $178 billion and then I look at the $13 billion cut this year, which the leadership says they cannot make. I mean, we are taking a first step of $13 billion toward a $178 billion mountain, and I say it just does not add up. There is something basically wrong. We need to sort of go back to the drawing board and get a whole new plan, and I am saying that as someone who has supported this program.

Do we not really need a whole new plan to do something with these tax cuts, or defer them?

MIDCOURSE CORRECTIONS NEEDED

Mr. STOCKMAN. Senator, I will respond to that by saying no. I do not believe we need a whole new plan; the basic plan is sound. But we obviously need midcourse corrections for a variety of reasons; estimating errors, legislative action shortfalls, the inherited momentum of past spending, and finally the unpredictability and volatility of today's economy, particularly financial markets.

But I would not think a midcourse correction is something to be avoided or something to be looked down upon. As a matter of fact, any business that finds in the second quarter of its year that it is not meeting its projections and its business plan for the year, goes to the well immediately to make changes in order to get back on track.

Senator JOHNSTON. Well, I am not saying we do not need——

Mr. STOCKMAN. What we have to do here, I believe, is get back on track. There are bigger problems than any of us anticipated, and what the President suggested in his September 24 speech was a dialog with the Congress to figure how we get back on track.

But certain things have to be kept in mind. We needed to lower the rates of taxation on income and investment. We have achieved that. We needed to lower the budget growth rate from 15 or 16 percent to somewhere in the sustainable range of 5 to 7 percent; we are part way there.

The entitlements and the automatic expenditure programs still need more tightening; we have to work on that. The President has suggested that revenue enhancement should be considered now as part of the picture. It seems to me we have got to look at all of those options and come up with a game plan around which a political consensus can crystallize, and that legislative action, then, can move forward.

We think we have the best proposal, but obviously there is no monopoly on insight and no monopoly on the correct solution at the present time. We are looking forward to what will be proposed by this committee and others in the Senate and House.

Senator JOHNSTON. Thank you.

Chairman DOMENICI. Senator Armstrong.

PEOPLE CONTINUE TO SUPPORT BUDGET CUTS

Senator ARMSTRONG. Thank you, Mr. Chairman.

Mr. Stockman, you have already gained the impression, I am sure, from some of the members of this committee and from others that you have been visiting with that a lot of the Members of Congress think that you are sort of playing the Don Quixote in this scenario, tilting at windfalls, and that, in fact, getting the genie back in the bottle is going to be an impossible dream.

My own opinion is just the opposite; not only that it is a fully possible dream, but that you are going to win and a year from now, people are going to look back and say, "Why was it not plain to us a year ago that David Stockman and Ronald Reagan were absolutely right and that, in fact, they would prevail and that the budget cuts would be made?"

I will tell you why I say that. It is because I sense that despite the skepticism among some Members of the Congress, the country is really in stronger support today of what you and the President are trying to do than they have ever been. I want to give you two anecdotes and then I want to ask you a question.

On Monday night of this week, I was in Pueblo, Colo., at a meeting of about 600 people celebrating the annual Columbus Day event. And I do not suppose that out of those 600 there were probably more than about six members of my political party. Pueblo, as you may know, is the stronghold of the Democrats in Colorado.

I had many people, including many of the local officials there, sidle up to me during the course of the evening and say, "Tell the President to stick to his guns; we are ready for the budget cuts," and I have heard that over and over and over again. In fact, before I came to this meeting this morning, we checked with one of the pollsters whom I have relied upon over the years, who tells me that over 65 percent of the people in his latest surveys continue to support the budget cuts. A plurality of people who say they think they personally will be hurt by budget cuts—even among that subsample, a plurality nonetheless support those efforts.

So, the message which I have been asked to transmit by the people out in Colorado is stick to your guns and do not be dissuaded from your course of action.

MEMBERS WARNED OF MORE CUTS

The question I want to ask you is this: Is it the intent of the administration that what you have proposed—the round of cuts which you have presented today—is this something different than you talked about in March?

I gained sort of the impression just from the earlier discussion that maybe some members of the committee thought this was unexpected. I seem to remember that you testified in March and the President when he sent up his message, said he would be back with another package of cuts. Have I slipped a cog on that?

Mr. STOCKMAN. No. I think you were correct, and again I refer to the first budget resolution, which was an effort to implement, with some modifications, the basic tax and budget plan that the President proposed. Very clearly, in that resolution, it commits the Senate and the House to $35 billion in additional savings in 1983 and $45 billion in 1984.

We never said that the entire problem should be solved in one massive piece of legislation; it simply was not doable, digestible, or logistically feasible. But somehow the charge that now recursis, that the whole plan was adopted in July and August and that the results are not apparent, and some are saying "why are you now asking for more?" This position seems to me to be either naive or deceptive. It was very clear all the way through in our debates and our discussions that this was the first installment, not the final action.

Senator ARMSTRONG. Well, as I look back on the last 4 or 5 years of policymaking, it appears to me that the biggest single mistake that President Carter made was to zig-zag and to change his course of action repeatedly. I hope that this administration will not do that; that you will stay on a steady course.

I understand that it will have to have some fine tuning, but I was not surprised when you sent up a package of September cuts because you had warned us that that would happen. In fact, if you did anything else, I assume that the financial markets and the general public would have been thunderstruck and it would have been a very disconcerting thing, which brings me to the last question I want to raise this morning.

PRESIDENT WILL VETO BUDGET BUSTERS

I really do not think this is going to happen, but suppose we are unable to get the cuts through the Congress that you have suggested and Congress insists on sending to the President a series of spending measures which exceed the targets that you have outlined. Will it be your recommendation that the President veto those bills?

Mr. STOCKMAN. Well, Senator, I think the President has made very clear that he will veto budget busters. He has reserved the option to appraise each bill, particularly appropriations bills, that comes along. But it certainly is my intention to recommend that he veto bills if they are way over the budget and exacerbate the deficit problem in 1982 or in future years.

Senator ARMSTRONG. Good for you. I am convinced, as I have shared with a number of my colleagues on a number of occasions, that the No. 1 problem we face is the interest rate credit crunch and that there is absolutely no way we are going to bring interest rates down permanently to a manageable level unless we get spending under control.

Chairman Volcker was here and testified that he could not control interest rates unless Congress does that. It appears to me that the President cannot. I do not know of any power on this planet that can bring those interest rates down if we insist on the kind of massive deficits that will occur, absent some budgetary restraint.

So, I guess I just join with the people out in Pueblo, Colo. and a lot of other places in saying stick to your guns.

Mr. STOCKMAN. Thank you.

Chairman DOMENICI. Thank you, Senator.

Could I just remind the Senators and for the record indicate that the minority asked that we have an additional hearing, Senator Hollings, and we have now scheduled and notified everyone that Dr. Sprinkel, Larry Kudlow, an economist from OMB, and Jerry Jordan from CEA will be here as a panel on Tuesday at 10 a.m.

The additional request was that we ask the Secretary of the Treasury to appear, and I have tried my best to get that arranged quickly. My note to every member of the committee indicates that his earliest opportunity is October 27, Senator Hollings. So, what I have indicated is that we have scheduled him, but if we decide to proceed to mark up before that, we may have to proceed. If not, we will have him. I tried to get him sooner, but there is just no way. He is testifying and is on a trip with the President, and that is the earliest date.

So, we will have, for certain, at 10 a.m. Tuesday, Dr. Sprinkel of Treasury, Jordan of CEA, and Kudlow of OMB. Now, I am going to yield to Senator Hollings at this point; he has not had an opportunity to question.

SECOND ROUND FOR TAX CUTS, NOT TAX INCREASES

Senator HOLLINGS. Well, Mr. Stockman, we either build you up or tear you down. You have just been built up; it is not my intent to tear you down. But it should be said for the record that our distinguished colleague, Senator Armstrong, is incorrect.

I cross-examined, trying to find out—it is somewhat the frustration that Senator Johnston now has and I still have—what is the complete plan. We cross-examined in March and May, and we can go to the record of those meetings, and you said that future cuts will be designated in future years.

The second round was a second round of tax cuts not spending cuts. Do not ever leave here, anyone, with the idea that we got victory in August, which I congratulate you on, generally—I supported that—and then come back and say, "Oh, my heavens, the whole program now is awry and we have got to have a second round of spending cuts." That is what Silvio Conte is telling you on the front page of the newspaper—your own ranking Member in the House on appropriations.

They have been bloodied in the trenches enough; that is what your own chairmen over on the Senate side are telling you. Yes, you said a second round, but you said you would get them to us in future years. Your second round this year was to be for tax cuts, not tax increases, and that is what you have given us—tax increases—and that was before the President's program took effect.

The President elected to go on national TV. Before the program could take effect, he went on national TV and instead of the second round of tax cuts, we got a second round of tax increases, and instead of increases in defense, which we were all prepared for, now we are all talking about cutting defense.

We seem to talk a different language. The very first day when you and I had an exchange, you said no one was to blame about bigger budget deficits. "These are empirical happenings. We simply confront an empirical fact of life, facts and circumstances, that are not our doing, but are inherited and are a common problem for all of us. No one is to blame."

UNREALISTIC FIGURES USED

That is inaccurate. If you and I could only talk the same language. We have said long ago that you were going to spend more than $695 billion. You are going up to $726 billion because of your faulty estimates of inflation and program spend-out rates. You have used unrealistic figures; do not use unrealistic figures and then say no one is to blame.

Now, right this minute, with regard to the entitlements, in the year 1984 you say $370 billion in your statement. You have 1984 budget outlays of social security and major entitlements, and they add up to $370 billion. Right this minute as you and are I talking, we have a $30 billion difference there; it is over $400 billion according to CBO. That is why we are not talking the same language.

Right here when we are trying to get a consensus and have a dialog and get together, why are we in this difficulty? And I will agree with you that we do not need a new plan; I would like "Reaganomics" to work. If it worked, I would be thousands of dollars richer, I can tell you that. [Laughter.]

And if it hurries up and works, I might recover. My hope is to recover myself by this time next year in October. If I can go back to where I was on August 12 before you signed it into law on August 13, I would be happy, and that is the way the average American is trying to do it. The other group is trying to survive these high interest rates.

COMPREHENSIVE PLAN

Why not give us a comprehensive plan? We have given one. You give a piecemeal operation; the President does. When he comes on TV, he says $13 billion in spending cuts, plus $3 billion in increases, is $16 billion. But we are looking for $100 billion, so it is totally inadequate.

You come now with your statement before the committee, and you do not have all the particular cuts ready in entitlements just for this next year. And then in the out-years here, in accordance with your statement, you have got some $11.7 billion yet to be identified in fiscal year 1983; $23 billion yet to be identified in fiscal year 1984.

Do you not know that those interest rates do not go down until, as you say, we head in the right direction toward a declining deficit picture? They see no declines by way of promises or study commissions. That is your trouble.

I mean, we are talking a different language on the one hand, and you are totally out of it. You underestimate your spending and you have underestimated your tax cuts. Your tax cuts have gone way overboard from what you originally asked for. You asked for, in 1985, $185.7 billion; that is what you just said a little while ago and what you really asked for.

Now, you said you have got none of the shelters or the loopholes or the add-ons. In 1985, instead of $185.7 billion, you have got $199.3 billion. Instead of $221.7 billion in 1986, you have got $267.6 billion. Do you see what I am talking about?

Now, have you been able to compute the shelters, the loopholes and the add-ons that you did not ask for? I know they were part of a compromise in order to get a bill. Let us make a midcourse correction; let us say "Reaganomics" has prevailed and it has won. Let us give the President his business tax cuts that he has asked for; let us give him his individual income tax cuts to 5 percent that he asked for. But let us try to make that midcourse adustment, so now, here, in October, the business community can see a comprehensive, real, credible kind of plan, whether they agree with it or not, that will actually pick up that $100 billion now for 1984, not study commissions and not promises to be identified later. That is your trouble.

Now, I might as well complete the thought. Some believe that Senator Armstrong and others love that high deficit, and the game plan is really to keep the deficit way out there bigger than any kind of plan to solve it. And as long as we can keep a bigger deficit, we can keep cutting those governmental programs and cutting those democratic programs, and keep on cutting and cutting and cutting.

If that is going to be the strategy, then I am going to have to do my best to flesh out you and this administration and show who is really responsible for the high interest rates, which is the cost of that kind of strategy and which is wrecking Main Street.

Now, if what we are going to do is keep the deficit way out in the offing and never really attack it because we do not want to—according to Senator Armstrong, he does not want to attack it. According to Congressman Kemp, he does not worry about a deficit; we do not worship at the shrine of the balanced budget. I think you do; I am not sure. I am trying to get a fix on you. [Laughter.]

You use that language a little every now and again, but you never give us any plan to eliminate a deficit. Why not?

$80 BILLION CHANGE IN BUDGET POSITION

Mr. STOCKMAN. Well, Senator, I am just going to have to take strong issue with you there. We gave you $160 billion worth of detailed policy change over 3 years in March. You adopted $135 billion of that—major changes, unprecedented changes.

For once, we capped entitlements rather than expanded them, as we did for a decade. Now, we have said that there is $115 billion additional to be changed in the budget position over the 1982–84 period. We have sent up here a game plan for $80 billion of that. Some of your colleagues do not like it; some of your colleagues have a better mix.

We are not talking about a study commission. I have on my desk right now a 200-page notebook full of the detailed policy changes in Federal civil service and military retirement, food stamps, medicare, medicaid, and all the other programs that will be up here in legislative form within a matter of 7 to 10 days.

I think that is not a general recipe; it is a specific proposal. It goes a long way to closing the remaining gaps, and I think if we were to meet here in a week and a half, the question would not be that we have not proposed enough; the question would be about a dislike for what we have suggested.

So, I just cannot agree with your argument that we are indifferent to the deficits or that we do not have detailed plans for legislative action, because clearly we do.

Senator HOLLINGS. Where do you get the $80 billion? Are you back to the entitlements, because that is $30 billion of it—the difference in 1984—which we have on entitlements?

Mr. STOCKMAN. No. We have indicated that of the $15 billion gap that Senator Johnston identified, we would get $13 billion out of a slowdown and tightening of the defense buildup. We would get another $22 billion as a result of closing loopholes, eliminating obsolete incentives, and so forth.

Through entitlement reforms, which are permanent changes in law to be enacted this year but will have future year effects, we would identify $28 billion. And through the 12-percent reduction or hold-down in 1982 appropriated or discretionary accounts, we would save another $17.5 billion over the 3 years. Now, that adds up to $80 billion. That adds up to three-fourths of the problem that we have identified that has to be addressed if the deficit is to be brought down.

In a sense, that $80 billion is a way of redeeming the $80 billion pledge you made and other committee members made when you passed the first budget resolution and promised that $35 billion in 1983 and $45 billion in 1984 would be saved out of the budget estimates used as the basis for that resolution.

ENTITLEMENT REFORMS

Senator HOLLINGS. Where do you get the $27 billion in entitlement reforms? What is that breakdown?

Mr. STOCKMAN. What does that consist of?

Senator HOLLINGS. Yes.

Mr. STOCKMAN. We indicated that a package of detailed proposals covering every Federal entitlement other than social security will be delivered to the Congress within a matter of days for inspection, review, debate, and hopefully legislative action this fall.

Now, we had anticipated earlier that those additional changes would be part of the 1983 budget to redeem those unidentified savings. We have accelerated the timetable because we have learned that there is a long lag in the legislative process and the implementation process. If we were to hold off with these entitlement changes until the January budget, you would not get it marked up until May; you would not get a bill to implement it until June or July or August, at best. We would run into next year's election process.

What we are doing is advancing the timetable, at least in terms of our detailed proposals, for achieving these savings that you have been asking for.

Senator HOLLINGS. You are advancing them, and I agree with you, because you said we were not going to get them until next year and now you are advancing them, and that is the fact.

We are going to have to do something, and you cannot expect any reaction when we still do not have the entitlement reforms.

Mr. STOCKMAN. We are not expecting that, and we are only asking——

Senator HOLLINGS. We see the leadership right now, with your closing loopholes and defense cuts and discretionary cuts—they are not responding to those. You know how difficult it is to close loopholes.

Let me stop; my time has expired. I am sorry. Go ahead.

Chairman DOMENICI. Senator Chiles.

USE COMMON SET OF ECONOMIC ASSUMPTIONS

Senator CHILES. Mr. Stockman, I first want to say that we are looking forward to having you at the University of Florida Blue Key banquet tomorrow night and I look forward to seeing you there.

I want to try to get some of the numbers straight that we have been talking about in your testimony. After we take the cut that is proposed for defense and then we exempt social security and the interest on the public debt, it appears that under the administration figures, we are $42 billion short of balancing the budget in 1984. CBO is estimating a gap of $94 billion. That $94 billion gap is going to require a 36-percent cut across the board, if we are going to balance the budget.

Is not part of our problem with the financial markets and interest rates the fact that the administration figures are not being accepted by the general public and by the financial markets? And would we not be better off if we really could go to a common set of figures and use the CBO's figures and just work from there? At least we would not be dealing with what appear to be deficits that are going to be higher and higher.

Mr. STOCKMAN. Well, Senator, I agree with half of your statement. I think we should have a common set of economic assumptions to be used both in the congressional process and to formulate our own budget. To the degree possible, we ought to get a meeting of minds among the technicians on the spendout rate estimates as well.

However, I do not think that that can be a one-way street. I do not think it would be valid or even prudent for the members of this committee to assume that CBO is always right and we are always wrong, because there is a lot of experience that has suggested that in some parts of this, they have been more wrong than we have.

Senator CHILES. Everybody has been wrong on the low side so far, including CBO.

INTEREST RATE ERROR

Mr. **Stockman**. No; this year, we have all been wrong on the high side on inflation. The inflation rate is running lower than CBO or the administration predicted in February. We have been wrong for 2 years in a row—CBO and the administration, Carter and Reagan—on the interest rate.

Senator **Chiles**. Right.

Mr. **Stockman**. As a matter of fact, the only time at which there has been more of an error on the interest rate is in the 1981 budget where, in the first resolution adopted by this committee, you used a 9.7 percent interest rate for 1981, when it turned out to be 15 percent. The next largest error was our error in 1982.

Senator **Chiles**. Well, where did we get that 9.1-percent interest rate?

Mr. **Stockman**. Well, Senator Hollings was the chairman of the committee at the time, and I am not sure where he got it—apparently, from CBO.

Senator **Chiles**. Well, if my memory serves me right, if you added the composite of the figures, interest rates and inflation, and added real economic growth in there, too, then every administration I have been following has been overly optimistic. CBO has also been overly optimistic, but not as optimistic as they might have been.

UNIFORM FORECAST

Mr. **Stockman**. Well, Senator, just to solve that, I have committed publicly to this committee and the House Budget Committee that in the next several months, we will meet intensively with CBO. It is my goal to have a uniform forecast, because the policy decisions we have to make about revenues, entitlements, and spending are so important that we should not be required to spend our time debating economic assumptions. We ought to be looking at the policy decisions and the budget decisions which are the real object of this whole process.

And I hope next year, we will avoid completely the kind of debates we have had over economic assumptions this year.

INTEREST PROJECTION RAISED

Senator **Chiles**. Well, I hope so, too.

I understand now that the administration has raised their interest projection from 10.5 to 12.5 percent, is that correct?

Mr. **Stockman**. That is correct, for fiscal year 1982.

Senator **Chiles**. But to my knowledge, you have not changed any of the other forecasts. Do you think we can raise that interest and not have that run through and affect everything else?

Mr. **Stockman**. In 1982, I think that that is a plausible change to make. In fiscal year 1982, our real economic growth rate is not that large. On a fiscal year over fiscal year basis, it is about 2.7 percent; on a calendar year basis, it is 3.4 percent. That is not that much different from CBO at the present time.

Senator **Chiles**. Do you think that is going to affect the unemployment rate?

Mr. STOCKMAN. It will have some effect on the unemployment rate. We have a relatively high unemployment rate assumed for 1982—calendar year, on average, 7.5 percent.

CUT OFF-BUDGET BORROWING BY $21 BILLION

Senator CHILES. In your September 24 press release, you said that you were going to cut off-budget borrowing by some $21 billion. At that time, you did not tell us what programs you wanted to cut. Can you tell us now?

Mr. STOCKMAN. Senator, those individual program decisions are being reviewed by the President and other senior policymakers at the present time. We intend to send out new lowered ceilings soon.

Chairman DOMENICI. What was the question, Senator Chiles?

Senator CHILES. The $21 billion that they were going to save by cutting off-budget borrowing.

Chairman DOMENICI. Thank you very much.

Mr. STOCKMAN. We intend to send out new ceilings to the agencies at roughly the same time that the entitlement package and the tax expenditure package come to the Hill, within a matter of a week or 10 days.

Senator CHILES. Well, I agree overall that it is critical for us to hold down activity credit in order to relieve pressure on the money markets. I worry about the timing of this restraint and whether you are going after the very sectors that are suffering most due to the high interest rates. Housing, agriculture, small business—these are the people that are the victims rights now more than anyone else, and they are suffering the greatest economic slow-down.

Are they going to be hit again by this off-credit——

Mr. STOCKMAN. Well, it is in those areas that you have itemized that the loan guarantee programs have been created. But as I have indicated before, a 100-percent Federal loan guarantee is the financial equivalent of a Treasury bill or a Treasury bond; it is just more deficit financing by the Federal Government.

However meritorious or worthy some of the claimants may be, it does not take away the fact that this year 50 percent of all available credit will be absorbed by Federal and federally assisted borrowing, for a total of $83.7 billion in borrowing on the regular, on-and-off budget basis.

So, no, I do not think it would hurt. I think we ought to let the market allocate the credit.

CREDIT ALLOCATION

Senator CHILES. Well, where is the market allocating credit now? It is for the Conoco merger; it is mergers that are going on in the biggest companies that are eating credit up. It is the energy companies that are flushed with money which are buying other companies; it is the defense companies that are flushed with money.

Now, we are talking about a sector that cannot get credit—the small businessman, the farmer, and the person engaged in housing. You are going to take away the credit that is out there for them.

Mr. STOCKMAN. Well, I guess I would prefer not to second-guess the credit allocation in the market, and I do not think there is any bureaucratic instrument nor legislative decision that can do that. I would suggest that the merger wave that occurred for a couple of weeks there was a very transitory thing; it has not persisted.

Senator CHILES. You do not think it is continuing now?

Mr. STOCKMAN. I do not think there is any evidence that it is——

Senator CHILES. My paper says that a Federal judge has just said that LTV has got to hold up in its acquisition of Grumman. That is a merger, is it not?

Mr. STOCKMAN. Well, Senator, I would just disagree with you that one merger is of any significance. When a company buys another company and pays cash that it borrowed, that money does not go into a mattress; it gets used. Credit constantly recycles through the markets and through our economy.

I do not think mergers are really significant in terms of what is happening in the financial markets today.

Senator CHILES. Well, I think that is exactly the perception that this administration seems to have: big is not bad; big is beautiful. Let the big times roll; let the mergers roll. That is exactly what is happening.

I have a hard time telling a small businessman who cannot get credit that it is all right to have all this credit allocated to big companies, but that he cannot get credit.

Mr. STOCKMAN. Well, the unnecessary borrower there is the Federal Treasury—some $80 billion. It seems to me that the one borrower we can control as public officials, you and I, is how much we spend and how much we borrow. And rather than try to second-guess the structure of the industrial economy and whether it is good or bad for Exxon, for instance, to enter the word processing business and challenge IBM—I do not think that is a primary object, or should be, of our attention.

What we should do is take the big borrower out of the market—the guy with the sharpest elbows; that is, the Treasury.

FINANCING TAX CUT WITH RED INK

Senator CHILES. Is not the Federal Treasury going to borrow to give the tax cut to the big people again? Is it not the Federal Treasury that is borrowing money to pay for the tax cut?

Mr. STOCKMAN. I do not think the Government ever borrows money in order to allow people to keep income they earned.

Senator CHILES. Well, is the tax cut written with red ink?

Mr. STOCKMAN. I do not believe so.

Senator CHILES. I am glad to hear that. [Laughter.]

Mr. STOCKMAN. You can raise a question about whether it is practical and feasible to cut spending to a level that would fit the revenues that will be generated with the current tax code. But that does not mean that the tax cut is financed in red ink. It is a practical legislative decision tbat you have to make.

I would say that we are going to collect with this new tax bill—despite all the rhetoric about starvation and denying the Government's income, we are going to collect $3.9 trillion over the next 5 years. I think it is a fair proposition that we can fund the Government—defense, social security, and everything else—on $3.9 trillion.

Other members of this committee disagree. We ought to debate that and make a decision.

Senator CHILES. But we are talking about the recent tax cuts that we enacted and whether or not they are coming out of borrowed money at a time we are operating at a deficit.

Mr. STOCKMAN. Would you be opposed to that?

Senator CHILES. We are talking about whether the tax cuts should be higher than the spending cuts that we are making.

Mr. STOCKMAN. Well, Senator, I would say that if you oppose the idea and if that is the way you would formulate it, of cutting taxes and financing them with red ink, then there are plenty of legislative opportunities to do something about it. I just do not agree with your——

Senator CHILES. You are the one that pointed the finger at the Secretary of the Treasury and said it was the Treasury that was borrowing the money and causing all of our problems. I am just pointing out to you that when he goes to borrow that money, he is borrowing billions to make the tax cut; that is why he is borrowing it.

Mr. STOCKMAN. Well, in 1981 there was no tax cut; that was all spending that he was financing. In 1982, the tax cuts start very slowly. I think the revenue loss is $37 billion. Spending will increase by a minimum $60 billion in 1982 over 1981. I think it is a pretty debatable proposition whether at any time soon the Treasury is out there financing a tax cut that apparently you do not agree with.

Chairman DOMENICI. Senator, your time is up. I really did not cut you off. Your time was up a while ago, but you were doing all right, so I figured I would let you go. [Laughter.]

Senator Grassley.

ADMINISTRATION COMMITTED TO TAX CUTS

Senator GRASSLEY. David, I am going to continue Senator Armstrong's line of questioning a little bit, and make reference to the Evans and Novak piece of yesterday.

Before I do that, however, would like to refer to a question I asked you in March concerning the extent to which the President would stick by his program. We discussed the extent to which the President would have to compromise some programs in order to have them adopted.

I do not think the President has compromised any basic principles at least to the point that I am bothered to any great extent. Basically, I think we have enacted the program he desired. Even though you very diplomatically avoided giving away the President's position on compromose in our March discussion, I am satisfied now that the President has stuck by his guns.

But then I am reminded of this editorial and of what you say about a $100 billion deficit. Of course, I would be horrified about that, too, but more so, I am concerned about the extent to which you might be willing, as an adviser to the President, to allow some sort of relaxation of the tax cut. I would see that as a major aberration of the President's economic policy. Just think of what that might do to those in Congress who have supported the President, and to the investors and consumers who are trying to ascertain whether the policies of this administration and Congress are really different from the past.

Mr. STOCKMAN. Senator, let me respond to that by suggesting first that there is some considerable risk in introducing an Evans and Novak column as evidence in a congressional hearing. [Laughter.]

Mr. Novak often knows more about one's inner thoughts than one knows himself. In this case, I am totally puzzled as to where he developed that line of argument and reasoning. My very clear suggestion to you is that the last thing we would ever want to do is delay the implementation of the business and individual tax cuts.

We have said we might need more revenue, and we have talked about the loopholes and tax expenditures and maybe excise taxes, and that sort of thing. But it seems to me the last thing we want to go after is to put this burden right back on the backs of the people who have been bearing it for 10 years—the productive, enterprising sector of our economy.

So, I do not know that anything more needs to be said, except that the $100 billion deficit figure is a guess. There is a serious deficit problem in the out-years. We had better find the expenditure reductions, the entitlement reforms and the revenue measures that we need to get that closed. The impact of this tax cut to which you and we are so committed will be nullified if we do not get the financial markets stabilized and the interest rates down.

FINE-TUNING MONETARY POLICY

Senator GRASSLEY. On another point, I think that if interest rates were lower, most everybody would feel that we were really going in the right direction. I tried to use the same explanation that you used: if the government spends less and borrows less, interest rates will come down.

There is generally a strong support for the President's program of cutting expenditures, but I do not think the people have quite seen the relationship between the government spending less and the interest rates eventually coming down.

People have suggested what we refer to as "fine tuning" as a cure to our high interest rates. Are there really any short-term measures we can take that would reduce interest rates for the long term?

This suggestion comes mostly from those in the homebuilding and real estate business as well as farmers and small business people. Is there anything substantive that can be done?

Mr. STOCKMAN. Well, Senator, I am not sure what you are suggesting. Are you suggesting fine tuning of monetary policy?

Senator GRASSLEY. Yes; and I know that is Federal Reserve, but I know that Secretary Regan and Chairman Volcker meet regularly, and I have read what Secretary Regan says in the press.

Mr. STOCKMAN. Well, my answer to that would be we have been fine tuning monetary policy for the last 6 or 7 years. We have constantly fine-tuned it in a direction of more expansion, more money, beyond the capacity of the economy to absorb it without an increase in inflation.

We have finally turned the corner on that. The inflationary momentum in the economy is abating, and to start fine tuning now would be to interrupt that basic disinflation process and it would only further undermine confidence in the financial markets.

The fine tuning in the last 4 years has gotten you the following: a Federal 20-year bond issued in 1977 at $1,000 face value is worth $520 today because of all of that fine tuning, all of that inflation, and the permanent upward ratchet of the interest rates that resulted.

It seems to me if you want any explanation as to why interest rates are high, just ask yourself if you were in the market to buy a bond and had bought one in 1977 and it was worth half its value today, would you be inclined to go back out there again without an awfully high yield? The answer is no.

I do not think we are going to get interest rates down until we indicate we will not tinker with monetary policy and that we are going to solve the problem where it started: in the huge deficits that we have racked up year after year.

Senator **GRASSLEY**. Mr. Chairman, I am through.

Chairman **DOMENICI**. Thank you. Senator Exon?

INTEREST RATE ESTIMATES

Senator **EXON**. Thank you, Mr. Chairman.

Mr. Stockman, I would just like to pursue this interest rate matter with you a little bit more because I agree with the thrust of the questions that have been made that that is the No. 1 problem of many that we have today, and I am sure that is concerning you.

When you were here the last time, you revealed I think publicly for the first time in response to my questions that you had raised the average—I assume you were talking about the 90-day T-bill rate—to 12.5 percent from 10.5 percent, which was your estimate in midsummer.

There was some question here about where we were on estimates on interest rates early this year. If I understood you correctly, you said that the 8.9 percent came from this committee. What was your estimate on interest rates when you took office and when you came out with your first projection?

Mr. **STOCKMAN**. For fiscal year 1982, I believe it was about 9 percent.

Senator **EXON**. So, you were right along with this committee, even if we were wrong.

Mr. **STOCKMAN**. Well, Senator, I guess we were all wrong on interest rates. I was referring to 1981 and the budget resolution passed in June of 1980, which suggested that during calendar year 1981, the average T-bill rate would be 9.7 percent. It turned out to be 15 percent. I was only pointing out that the errors tend to be symmetrical. They are made up here and downtown with equal magnitude.

Senator **EXON**. I think that one thing that we are continually overlooking is the reliability of what we do here. Now, it is very clear that in the spring, you said 9 percent; in midsummer, you said 10.5 percent. Now, in the fall, you say 12.5 percent. That is a 30-percent error. I am not saying that you cannot make errors like we can.

The signal that we are sending with those kinds of errors in estimates of the responsiveness of the economy—even though we did go ahead and do almost exactly what the President wanted us to do, in my opinion, the signal being sent to the money markets and to the people is that we are so far off on our estimates up here that we cannot get things in line.

What is your explanation, or what is your excuse? What do you think we should do about that?

USE CONSERVATIVE INTEREST RATE

Mr. **STOCKMAN**. Well, Senator, I would just suggest that after the last couple of years in which interest rates have been so volatile—if you remember, in 1980 they started at 20 percent, went down to 10 percent, and back up to 20 percent within the course of 8 or 9 months. When we prepare a budget, we are projecting out to 18 or 20 months, at least.

There have been so many errors, both from the administration and the Congress, that next year we would all be well advised to use a very conservative interest rate, and that is what we intend to do. Now, if that overstates the potential level of spending in the budget, I think that is a risk that we should run because I agree with you completely; it tends to undermine the credibility of policy and it is something we should avoid in the future.

WHO ACCEPTS BLAME IF ECONOMIC PROGRAMS FAIL

Senator **EXON**. Mr. Stockman, I guess I consider you a worthy idealist. I do not know how practical you are, but I think you are a worthy idealist. I think, though, we must get realistic if we are going to solve the problem. It is not a Democratic problem, it is not a Republican problem, it is not a problem of the Congress or the administration. We are all in this boat together, and I think we have critical decisions to make in the future.

There is some perception that you, among others, in your talks and in your television appearances and, indeed, in your appearances before committees of the Congress, are trying to set up the Congress as the fall guy for the failure of the economic programs of the administration. I want to give you a chance to respond to that. Are you trying to do that?

Mr. **STOCKMAN**. Senator, I assume the program will not fail, so I have not bothered to think about who might be blamed.

Senator **EXON**. But you have on many occasions, at least from my watching you, seemed to be leading us down the course that if this does not work, it is going to be the fault of the Congress. And you should recognize and realize that the latest recommendations that have come from you and the President are not even being accepted by the Republican leadership of either the House or the Senate.

Mr. **STOCKMAN**. Senator, I would just like to suggest that the Congress has to decide what it wants to do. Now, we have said we believe the Government is taking too much of the economy in taxes and spending.

Senator **EXON**. Well, we all agree with that.

Mr. **STOCKMAN**. Well, let me finish. We would like to get it down to 19 percent by 1984. To do that, we will simply have to reduce spending for functions that have built over the years that many people on the Hill would like to continue to fund.

Now, when I come up here and say that a farm bill pending in the House right now is $10 billion over the budget that we have allotted for farm programs over the next 4 years, I am not trying to blame the Congress. I am simply trying to alert people that if you voted for this plan last spring and summer, then you voted to keep the cost of the farm program low. And if you are unwilling to do that on this occasion or on a Labor/HHS appropriations bill or on some other legislation coming down the pike, then you had better decide whether you want a different policy—a high tax policy or a moderate tax policy—and then get behind those proposals that are necessary in order to achieve fiscal balance.

I am not saying the low tax route that we have proposed is the only way, but if you endorse it and if you voted for it, it has consequences. One consequence is to squeeze out some of the excess or the debatable activity that the Federal Government has built up over 10 years. I will keep calling that to the attention of the Congress until the Congress makes a decision to do something else.

TWO WAYS TO BALANCE BUDGET

Senator **Exon**. Mr. Stockman, I take it from the statement you just made that you recognize, despite the fact that it has not been very well enunciated, that there are two ways that you balance a budget. There are always two ways to balance a budget: control spending on one hand, and then whatever you agree the spending levels should be, have the courage to set the taxes to bring in the necessary money to fund what you passed.

Mr. **Stockman**. I agree with you completely.

Senator **Exon**. Do you think that there is any justification for the criticism that you and the administration have been emphasizing only one side of how we balance the budget rather than recognizing that there are two ways to balance a budget?

Mr. **Stockman**. No; I do not believe that from my own perspective and from what I believe are the President's very firm intentions. He believes that a tax system that produces a 9-percent growth in revenue every year between now and 1986, generates nearly $4 trillion worth of revenue to finance the Government, and takes nearly 19 percent of the GNP is enough revenue to meet those things that are the Federal Government's proper responsibility.

There are other Members of Congress who believe we should subsidize dairy cows, who believe we ought to provide local mass transit with operating subsidies, and who believe that we ought to engage in flood control projects that benefit localities rather than the Nation. If they believe those things, then they ought to have the courage to say, "We want higher taxes to finance them."

Our own view is that the proper responsibilities of government can and will be financed on 19 percent of GNP, and I guess that is the real debate that is before the Congress.

IMPROVE NATIONAL DEFENSE

Senator **Exon**. But you are overlooking something that was part and parcel and the main thrust of the campaign from your side last year, and that is that above everything else, we have to improve our national defenses.

Now, in those figures that you just used, I noticed that you did not say anything about defense.

Mr. STOCKMAN. Let me add that in.

Senator EXON. Let me finish my question. I happen to feel that we need to build up our defenses in this country. Has it ever occurred to you that because of the locked-in policy that you are following that we are going to cut taxes, come hell or high water, you might be damaging the national defense of this country and the free world by your actions?

Mr. STOCKMAN. I do not believe that that is the case at all. I would point out that from 1950 to 1970, we spent nearly 9 percent of GNP on national defense, and total Government spending was still lower relative to our business and personal income than it will be with this whole tax reduction fully in effect. We did it for 20 years; I think we can do it again.

The question is "Does all of this excess that was built up during the 1970's—when we stole from defense to build up all these domestic bureaucracies and social welfare programs of one type or another—have to continue?" Our answer is no; it can be scaled back.

If you want to do both—defense and the big build-up of domestic programs of the 1970's—you need more taxes, you need higher tax rates, you need a larger claim on the national income.

Senator EXON. Well, I would only point out to you that we went along with you—I think most of us at this table—in cutting back almost to the penny to the recommendations that you and the President made. Yet, after we did that, the policies that we were assured by you and others would work failed.

I thank you, Mr. Chairman.

Chairman DOMENICI. Senator Quayle, can you stay and conduct the meeting?

Senator QUAYLE. Yes.

Chairman DOMENICI. I have to leave. I wanted to ask Mr. Stockman how long he can remain.

Mr. STOCKMAN. Mr. Chairman, I have another appointment shortly after noon.

Chairman DOMENICI. All right. Then you will proceed, and I think Senator Moynihan has not had a chance; he will be next.

Senator MOYNIHAN. I can be brief, Mr. Chairman.

[Whereupon, Senator Quayle assumed the Chair.]

AFDC PROGRAM

Senator MOYNIHAN. Mr. Chairman, I will be brief, and I would hope that we can just get through two points here and see if we cannot agree on our facts.

I think you would support the general proposition that everybody is entitled to their own opinion, but not to their own facts. That is one of the things we often confuse in talking about the budget.

One of the scale-back measures proposed by the administration, one that you have been much involved with in the area of social welfare and which to some degree has already been cut, is the AFDC program, the program to aid families with dependent children. This is not a large program in the Federal Government, but as you know, it has received a very large amount of attention over the years, including a considerable amount of caricature and a considerable degree of distortion.

Last October 1, while you were testifying before the House Budget Committee, Congressman Downey of Long Island asked you about plans to reduce benefits for working mothers receiving AFDC benefits under the various work incentive programs established in the 1960's and 1970's.

You said, and I quote you, "We have documented evidence of $27,000- and $35,000-a-year people on the program." But as I understand it, Mr. Dale has been asked about that documentation and said that, in point of fact, there is none. Is there?

Now, if it was a mistake, then it was a mistake. We all make mistakes. But if it was, you ought to correct it.

Mr. STOCKMAN. Senator, I think the evidence exists. I was not asked to supply it to the committee; I will supply it to you. I recall very carefully reading a large body of profiles a few months ago which indicated that those were actual cases from the State records of Minnesota and a couple of other States.

Senator MOYNIHAN. Could we ask you for that, sir? We would appreciate it.

Mr. STOCKMAN. Yes.

MIDCOURSE CORRECTION

Senator MOYNIHAN. Just one other question. Last September 13 in New York State, I addressed our business council about fiscal prospects and deficit problems over the next 4 years, and suggested with unless we consider what I called a "midcourse correction" for the tax cut in the out-years, we will face an impossible situation in 1984 and 1985. At that time, your office was not very friendly to the idea, indeed a little derisive—as was its right.

But I gather this morning you yourself used the term "midcourse correction," and since we have used the same term, I wonder how you would distinguish what I said, if anybody brought to your attention what I said, and what you have now said.

Mr. STOCKMAN. Senator, I imagine there are a variety of courses that one could pursue by way of a correction. I would say, as I said earlier, I do not think all taxes are created equal. If it is the feeling of this committee and the Congress that we need more revenue and you could only squeeze the spending system so far, then I would much prefer to see that revenue obtained from tax expenditures, like the type that you championed earlier in the spring and included in the tax bill, or from excise or consumer expenditure taxes, rather than building marginal tax rates back up to higher levels on income, work, savings, and investment.

It seems to me that that is the last place we want to solve this equation. There are lots of other places—entitlements, spending, revenues—from nonincome, capital savings-related sources.

Senator MOYNIHAN. Well, that seems to me a perfectly fair response, and perhaps you will find that there is not such a difference between what I have proposed and what you are now proposing.

Mr. **Stockman**. Well, I understood your proposal was to delay the individual tax rate cuts.

Senator **Moynihan**. That is one possibility; there are many others. I also have said, perhaps to the surprise of some, that the Reagan administration could become a great era of tax reform. Because having depleted the Treasury to the degree you did with your final legislation, you are going to have to come back and fill it back up. Of course, it will to be called "closing loopholes" rather than "raising taxes"—a term of some art, would you not agree?

Mr. **Stockman**. Our term was revenue enhancement.

Senator **Moynihan**. Oh, yes. Revenue enhancement. [Laughter.] So, a midcourse correction that results in revenue enhancement of a desirable form—is what we can agree on?

Mr. **Stockman**. That is correct.

Senator **Moynihan**. Thank you very much.

LINK REVENUE CHANGES TO ENTITLEMENT SAVINGS

Senator **Quayle**. Thank you, Senator Moynihan. Let me ask just a couple of quick questions; I understand you have to go.

Isn't it true that some time we are going to have to link the cuts in entitlement programs with some sort of deferral of the tax bill?

I certainly agree that we should not fiddle with it right now; I think it would be the worst thing in the world. But if you are looking down the road, without the consensus that appears to be emerging on the second budget resolution, and talking with other Senators and Congressmen, do you not think that at some juncture we are going to get at that precise point?

Mr. **Stockman**. I think the juncture of which you speak is right now. To do anything serious about the fiscal year 1983 and 1984 budgets, I believe you are going to have to do it this fall, simply because of the lags and the delays built into the legislative and administrative process. I think the idea of linking revenue changes to entitlement savings so that the entire burden is not put back on the taxpayer to close this budget deficit gap is very meritorious.

Certainly, if you look at the package we have proposed, it is 4 to 1, spending savings versus revenue gains. And to go much beyond that, it seems to me, is simply to retreat to the policies of the past and try to balance the budget by taxing the economy harder. That would be a grave mistake and one that we could not cooperate with.

TAX BILL TO RESPOND TO REVENUE PROPOSALS

Senator **Quayle**. On your linkage of revenues and entitlements, are you absolutely ruling out, say, any deferral of the income tax or any changes in the tax bill that was just passed?

Mr. **Stockman**. There are some features of the tax bill that just passed that could be reviewed or perhaps even changed. But the heart of it was the 25 percent cut in individual rates, as well as the basic depreciation reform. We strongly insist and urge that that not be reopened. All taxes are not created equal. If you want to raise revenues, look at some of the items we have proposed, as well as other ideas that are being debated on the Hill at the present time.

Senator **Quayle**. On raising revenue, we will have to have a second tax bill, right?

Mr. **Stockman**. You would have to have a tax bill to respond to the revenue proposals we have made and will have up here shortly, as well as many of the ideas that are being discussed on the Hill. I believe we need another tax bill this fall in order to provide one component of the overall budget change that we needed to put this back on track.

Senator **Quayle**. One final question. You responded, I think, to Senator Hollings that you had 200 pages of reforms in entitlements, talking about food stamps, et cetera. Now, are you going to be sending up these reforms for all those specific entitlement programs? Will they be specific, individual reforms?

Mr. **Stockman**. Yes.

DEAL WITH ENTITLEMENTS ACROSS THE BOARD

Senator **Quayle**. Well, let me just suggest an idea, and then you can respond and leave.

In this whole entitlement area, David, I do not think we can take on each one of these programs individually. I would hope that maybe you might be able to use your intellectual wisdom, and some of the contacts and ideas that you may have, to come up with a comprehensive piece of legislation that is going to deal with entitlements across the board, and in that mechanism perhaps create a partnership of the executive and the legislative branches, where the legislative branch would establish targets and goals of spend-out.

As the targets and goals of spend-out appear to be overrun, whether it is in defense or whether it is in the area of food stamps or other entitlements, then the executive branch, without the concurrence of Congress, would have some flexibility to fine tune the entitlement programs to stay within those budget targets, rather than always having to come back for a supplemental.

I just think from a political point of view, you are just not going to be able to take on each one of these very well-entrenched special interest groups. It is going to have to be done in comprehensive, substantive legislation. I just offer that as comment and hope to entice your interest in it.

Mr. **Stockman**. Well, I think there is a lot of interest in your suggestion. However, basically, that would be delegating the policy job to the executive branch. An entitlement is a legal structure that provides benefits for people who meet certain conditions or criteria or qualifications; it serves certain public objectives.

I do not think it is likely that the Congress—at least the majority—would be willing to give the unilateral power to the executive to modify entitlements. There is only one precedent for it, and that is the Lugar amendment. The Lugar amendment to food stamps is a very blunt instrument—one that you would not want to use because it says if you are overrunning the target, you cut everybody's benefits equally, the 70-year-old retired person who needs the benefits and the 22-year-old single person who does not have a job and is on the food stamp program. That is the problem with legislative delegation.

Senator Quayle. Well, you are absolutely right that the Congress would not be willing to go along with any serious abdication of forming of policy. But it seems to me that there is going to have to be some comprehensive piece of legislation to deal with the so-called entitlement programs; that you cannot simply continue to nickel-and-dime these twice a year or three times a year.

I mean, the political clout of the administration or anybody that is trying to get into the entitlement programs is simply not there; the political clout is on the other side. I do not have to tell you that; you know that too well from being up here for 4 years. That is why I think something has to be done on a comprehensive basis. Otherwise, we will be spending the rest of our lives talking about entitlement programs and how we are going to get a handle on them. Everybody says they want to, but when it ratchets down to doing something specific about it, that is not the response. The response is to preserve the status quo.

So, I would just hope that in this 200-page reform package, it does not become too individualized and we could really give a serious look at some comprehensive reform where there can be joint cooperation with the executive and legislative branches, understanding the prerogatives and jurisdictional claims of both.

Mr. Stockman. Sure.

Senator Quayle. In the past decade, you have seen the legislative branch take quite a bit from the executive—war powers and impoundment control. Yet on the other hand, Congress has delegated to the bureaucracy unbelievable power in rulemaking and regulatory authority. I would hope that in the decade of the 1980's and under the theme of the new beginning, we might reexamine the whole balance of power, or the checks and balances and separation of powers issue.

I am the last one. Thank you for your indulgence and patience. As usual, you have been an outstanding witness.

Mr. Stockman. Thank you.

[Whereupon, at 12:04 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR TOWER TO OMB DIRECTOR DAVID STOCKMAN AND THE RESPONSES

CUT DEFENSE OUTLAYS

Question 1. Do you publicly and privately support the President's decision to cut no more than $13 billion in defense outlays over 3 years?

Answer. Yes.

OUTLAY VERSUS BUDGET AUTHORITY

Question 2. As you know, deeper outlay cuts will be extremely difficult to achieve in fiscal year 1982 because of slow spend-out in weapons procurement. Would you elaborate on the unique outlay versus budget authority problem the defense budget faces?

Question 3. Why is the Defense Department forced to give up $4 in the fiscal year 1982 program for every dollar of outlay reduction?

Answers (2 and 3). The defense budget is being reduced by $8.2 billion in budget authority and $3.0 billion in outlays from our March request, so the ratio of 4 to 1 is not accurate. It should be 2.67 to 1. In addition, there are lags between program changes and their effect on budget outlays in many portions of the Federal budget. For the defense budget programs as a whole, excluding direct payroll costs, a relatively small portion of spending occurs in the first year that the program was originally appropriated. In fact, between 30 percent and 40 percent of outlays occur in the year *after* the year for which funds were originally appropriated and during which they were obligated and about 20 percent of outlays occur 2 to 4 years later.

PROJECTION FOR REDUCED INFLATION IS REALISTIC

Question 4. What will happen if the rate of inflation assumed in the defense budget proves to be too low? This economic outcome would put upward pressure on defense outlays. Would the spending totals be adjusted upward to compensate for this or would such unanticipated increases be absorbed by further program cuts in defense?

Question 5. If it does turn out to be the case, what steps can be taken within the current economic environment to ensure that defense maintains an adequate rate of growth?

Answers (4 and 5). All Federal programs, including the defense budget have been developed as part of the President's overall economic program. We believe that our economic plan will result in a strong economy and that our projection for reduced inflation is realistic. Consequently, the President's recommendations for defense and nondefense programs are based upon his perception of our current needs and commitments.

I can assure you that both the magnitude and content of the 1982 military budget has been established through analysis of our genuine defense needs. We have every intention of meeting this major and necessary commitment by the President to strengthen our defense capabilities and to fund both the conventional and strategic elements of our entire posture that are required.

REDUCTION IN OUTLAYS

Question 6. When you endorsed this fiscal year 1982 reduction of $2 billion, did you realize the Department would have to reduce programs by $8.4 billion?

Answer. The $2 billion represents a reduction in outlays from the midsession review. We are reducing the defense budget by $8.2 billion in budget authority and $3.0 billion in outlays from our March request.

COMMON TYPE REDUCTIONS

Question 7. What are the common type reductions that are Government-wide included against the DOD outlay objective?

Answer. This reduction occurs in the area of retired pay and includes a shift to a once a year CPI adjustment as approved in the Reconciliation Act.

NO LOSS IN CONFIDENCE BY ALLIES

Question 8. How do we expect our Allies to have any confidence in our growth estimates or budget figures if you continue to force reductions on the defense totals? Won't NATO lose more than just the defense reductions?

Answer. No; I do not think that our NATO Allies will lose confidence in our commitment to build and maintain a strong national defense posture. The reductions we have recommended for defense do not compromise this goal—they do not affect the high priority readiness initiatives begun in 1981; military personnel goals for enlistments and retention and pay; strategic force improvements, and improvements in our rapid deployment force capabilities. Rather, these reductions involve stretch-out in selected procurement programs and accelerated retirement of older, costly to maintain and less capable units. Further, our NATO Allies realize that the budget process is iterative and requires the balancing of many programs and objectives within a viable fiscal and economic program. They realize that our long-term capability to supply a strong, growing defense program depends on a strong economy.

EFFECT OF REDUCTION IN DEFENSE OUTLAYS

Question 9. There have been several articles published recently pointing out that the change in the level of the Federal deficit is not a good indicator of the credit demands that the Federal Government is placing on the money markets. This is so because of the large volume of activity that takes place outside the budget in the form of off-budget Federal entities and government-sponsored enterprises.

If these factors are considered, as most believe them to be, does not the reduction in defense outlays seem like a very remote part of the overall economic picture?

Answer. The credit budget limitations, as well as reductions in both direct loan and loan guarantee programs by the administration, will reduce the level of both on and off-budget Federal participation in the Nation's credit markets. The administration's proposed reduction in defense outlays will further reduce the deficit and, in turn, will lower government borrowing needs.

VIEWS OF THE REAGAN ADMINISTRATION

TUESDAY, OCTOBER 20, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:17 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici, chairman of the committee, presiding.

Present: Senators Domenici, Symms, Grassley, Kasten, Gorton, Chiles, and Johnston.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will be in order.

Senator Chiles, in the absence of Senator Hollings, let me just see if I can put the hearings—this one and one remaining one—into perspective. At minority request, we have three economists here today. The other request was that we attempt to arrange for the Secretary of the Treasury to appear. I have indicated that the earliest date we could have him is October 27. We have reserved that time both for him and set it up on our schedule.

At this point, it appears to me that what I indicated in that response was that if we were not going to markup, we would proceed with the Secretary. It appears to me that we will be able to accommodate October 27 and that markup would occur after that. I will try to advise Senator Hollings late today.

If it is as it is now, that would be the schedule and that would be the end of the witnesses. So, with that, we will proceed. I have brief introductory remarks; I will make them a part of the record. They are just by way of introducing the three witnesses. So, I will let them do that, and if the minority has no objection, we would just proceed with the witnesses, unless you, Senator Chiles, have some opening remarks.

PREPARED STATEMENT OF CHAIRMAN DOMENICI

I wish to welcome our witnesses today as we continue to hear testimony from administration and other witnesses in preparation for the second budget resolution for fiscal year 1982. I will begin by introducing our witnesses to the committee.

Dr. Beryl Sprinkel is presently Under Secretary for Monetary Affairs of the Treasury Department. Dr. Sprinkel was formerly executive vice president and economist for Harris Trust & Savings Bank in Chicago and has authored several books on the effects of monetary policy on financial markets and the economy. As an expert in the field of monetary affairs, we are most pleased to have you with us this morning, Dr. Sprinkel.

Dr. Jerry Jordan was appointed as a member of President Reagan's Council of Economic Advisers this spring after serving for almost a year as dean of the Anderson School of Management in Albuquerque. Prior to moving to New Mexico, Dr. Jordan was senior vice president with Pittsburgh National Bank and senior vice president and director of research with the Federal Reserve Bank of St. Louis. Jerry is a friend from my home State and it is a pleasure to welcome you on your first appearance before the Budget Committee.

Finally, Mr. Larry Kudlow is the Assistant Director for Economic Policy at OMB. Mr. Kudlow brings to the committee substantial experience in financial markets as he was, until his appointment at OMB, chief economist and partner of Bear, Stearns & Co., a major Wall Street investment house.

Clearly, our panel brings to the committee expert knowledge in financial markets and monetary policy. I hope that you will describe for us this morning your views on the recent conduct of monetary policy, the effect of budget deficits on interest rates, and the outlook for the economy, particularly during next year. This is a broad agenda, but one which is important to congressional action on the second budget resolution. I wish also to thank our witnesses today for their forebearance in our many attempts to reschedule this hearing and I look forward to their testimony this morning.

Chairman DOMENICI. Let us proceed, then, with the witnesses. First, I thank you all for being here, and if it is all right with the three witnesses, we will start with Dr. Jerry Jordan, a member of the Council of Economic Advisers.

We do have your testimony. We have 2 hours, or maybe 2 hours and 15 minutes for the hearing, so if you desire to read your entire statement, it is all right with the Chair. If you can summarize it, it would be probably better for all of us.

You may proceed, Dr. Jordan.

STATEMENT OF JERRY L. JORDAN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Dr. JORDAN. Thank you, Mr. Chairman. I will summarize my statement and submit the full text for the record.[1]

FINANCIAL MARKETS AND INTEREST RATES

I want to go directly to a discussion of financial markets and interest rates. A commonly held explanation for high interest rates is the belief that improvement in inflation is going to be only transitory. There is a widespread view in the business community and in the financial community that despite the administration's programs, the actions by Congress so far, and the actions——

Senator JOHNSTON. Excuse me, Mr. Chairman. Could he pull the microphone a little closer?

Chairman DOMENICI. Yes, please.

Dr. JORDAN. And despite the actions of the Federal Reserve, there will be no lasting change in policy objectives and responses.

Chairman DOMENICI. Just a moment, Doctor. We are having a little trouble hearing. Would the staff see if that mike is working?

Maybe you could just talk a little louder or right into the mike.

Dr. JORDAN. OK, thank you.

There is a fear in the financial markets that money growth will soon turn expansionary again in the pursuit of short-run economic goals. So, if we are going to get a reduction in interest rates, not just for a few months or a few quarters but one that lasts for several years with truly low levels of interest rates, it is essential that we convince these skeptics that there has been a change in policy and that we are committed to a longrun anti-inflationary program.

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[1] See p. 295.

The worst thing that we could do would be to abandon monetary restraint in the short run. The financial markets would interpret this as a surrender to inflation, and the inflation premium and nominal interest rates would leap upward as they did in the summer and the fall of 1980.

CONCERNS OF FINANCIAL MARKET PARTICIPANTS

The concerns of financial market participants should be viewed in the perspective of the last 20 years. In the early 1960's, inflation had dropped to a little over 1-percent annual rate; short-term interest rates were around 2 percent or 2.5 percent on the Treasury bills. A more expansionary policy was adopted following the 1960 recession, leading to some acceleration in inflation and interest rates through 1965-66.

In 1966, we experienced the first major credit crunch, where short-term rates such as Treasury bills reached, at that time, an unprecedented high level of 5.5 percent, and that was considered to be unsustainable and that it would create severe stress in the economy.

We had a minirecession; policies turned very expansionary again. By 1968-69, we were back with the same kinds of problems, but with even higher interest rates. Then, again, in 1973-74, and now in 1980 and 1981, another new cyclical peak; each time we have gone through one of these cycles, short-term interest rates at the peak levels have averaged about 50 percent above the prior peak. When interest rates came down, they never went down as far as the previous trough before they started back up again, and the downswing was very short in duration compared to the upswing.

There is a commonly held view in financial markets that we are still on this longrun, upward, secular trend of interest rates. We may have a cyclical decline for a few quarters, and then start up again. And if you extrapolate from history, that would lead you to believe that short-term interest rates sometime in the next 3 to 5 years, will hit a new high peak in the 25 to 30 percent range.

If we reach those levels of short-term interest rates, of course, no one wants to be holding long-term securities. Long-term interest rates also would be rising. The only way we can get long-term interest rates to decline in a sustained way over a period of many years would be to have fairly low short-term interest rates due to the inflation premium being eliminated from interest rates.

RELATIONSHIP BETWEEN CPI AND COMMERCIAL PAPER RATE

I have included at the end of my testimony a chart showing the relationship between the Consumer Price Index and the commercial paper rate.[1] I have charted the 6-month rate of change of the Consumer Price Index against the 4 to 6-month commercial paper rate—the dotted line.

For the period of about 5 years as shown on the chart, you see that the correlation is quite good. The patterns are very close until late 1980 and 1981. If you extended the chart back for the earlier 1970's and the 1960's, the pattern is quite close. The spread between these two series was never more than about 1.5 percentage points.

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[1] See p. 303.

Now, in 1980 and 1981, we have a very wide discrepancy. Inflation in the short run has come down quite rapidly in 1981, and I show a dash-dot line running out through 1981 as the administration's projections for the Consumer Price Index through next year.

Believing short-term interest rates very high compared to inflation, we are expecting a lot of that gap to be closed during the next year. Some of it has already been closed in the last few months. When this chart was drawn, the commercial paper rate was around 16 percent. Recently, it is about 14.5 percent. We expect it to continue declining in the remaining months of this year and throughout 1982, and our projections, including the Treasury bill rate and the interest expense on the national debt, are based on the assumption that inflation will continue declining and that interest rates will be restored to a more normal historical relationship with inflation.

As short-term interest rates continue declining and get well below the levels of long-term interest rates, then we expect long-term interest rates to also gradually decline, although the decline in long-term rates, bond yield as well as mortgage rates, will be substantially slower than short-term interest rates.

For the economic activity in the third quarter, we will get figures this week that will suggest that it was flat, or maybe a very small decline. The fourth quarter that we are now in will also be about the same. If the recent decline in interest rates continues, then we expect that a beginning of a recovery will get underway early in 1982.

The deceleration of money growth in 1980 and 1981, together with a slowing of the growth of Government spending, has brought about a reduction in nominal income growth—total spending in the economy.

As market participants fully understand that we will not back from this slow and stable monetary growth and that we will persist in efforts to control the growth of Federal spending, we think that the way will be paved for a sound expansion of economic activity, gaining strength throughout 1982.

Because of current high interest rates and the lags in responding to the administration's program, real growth will probably be fairly modest during the first half of 1982, but we expect that by the second half of the year, the economy will be expanding in the range of 4 to 5 percent in real terms.

The combination of slow and stable money growth and declining inflation rates mean the long-term outlook for nominal interest rates is for a sustained, downward trend. In general, our economic forecast continues to reflect the responsible monetary and fiscal policy which has been advocated by this administration and will be adhered to for the duration, despite any short-term reverses in the economic environment.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Dr. Jordan, your entire statement will be made a part of the record.

PREPARED STATEMENT OF JERRY L. JORDAN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

I have been asked to focus my testimony on the outlook for interest rates and the economy for the coming year. In order to understand fully the significance of this Administration's economic policy and what portends for the future, it is necessary to place this policy in its historical context.

Over the past two decades economic policy in this country, broadly interpreted, has been on an unsustainable course. If one were to extrapolate the trend in each of the four major areas of policy, -- regulation, taxation, government spending and monetary growth -- any objective observer would be forced to agree that economic crisis was the inevitable result. Prior to the changes in policy inaugurated by this Administration, the ever-growing government involvement in the economy through increased regulation, and the reduction in individual incentives due to a rapidly increasing tax burden, sharply curtailed the prospects for economic growth in the 1980s. In addition, monetary growth accelerated throughout the 1970s, and many observers viewed high and accelerating inflation as a fact of life that one had to live with.

What this Administration has committed itself to is nothing less than a total repudiation of these self-defeating policies. Considering the scope of the problems we faced last January, it is remarkable how much progress has been achieved in so little time. You are all aware of the success this Administration and Congress have had in re-directing fiscal policy. These actions will contribute greatly to the growth and health of the American economy in the years ahead. The new direction in fiscal policy, looking out many years, has been largely enacted into law. This has given the American people new confidence that they can plan their own lives with some certainty that government will not change the rules in the middle of the game.

Just as we are committed to a fundamental redirection of fiscal policy, we are also committed to establishing a stable, non-inflationary monetary policy. All of these areas are interrelated and mutually reinforcing. This Administration's gaols of renewed economic growth depend crucially on both our monetary and fiscal policies. We cannot choose between them.

Monetary growth accelerated sharply in the 1970 giving rise to the high inflation, soaring interest rates, and the misallocation of resources from which we still suffer. This year, the Federal Reserve, with the strong support and encouragement of this Administration, has re-established a policy of slowing the trend growth of the money supply. So far in 1981 monetary growth is averaging below 1980's pace and that of several preceding years. This necessary restraint has led, with a lag, to a slowdown in nominal GNP growth. As we forecast at the beginning of the year, 1981 has been characterized by modest, if not slow, growth. Unsustainable real GNP growth of 8.6 percent in the first quarter was followed by a modest decline in the second quarter. There may have been another small decline in real output in the third quarter. For the first 3 quarters of the year, real GNP growth averaged around 2 percent.

The slowdown in money growth and government spending has also contributed to a substantial moderation in inflation. Inflation as measured by the GNP deflator has declined from almost 10 percent in the second half of 1980 to less than 9 percent in the first three quarters of this year. The improvement in the producer and consumer price indexes are even greater. This Administration's actions to decontrol oil and establish a credible antiinflation policy created a favorable environment for such beneficial developments.

The other significant feature of the 1981 economic scene is not a new development, but rather the delay of an expected development. Despite moderation in money growth, shortrun weakness in the economy, and progress made in fightining inflation, longterm interest rates rose further from their December 1980 levels. Shortterm interest rates, in contrast, have fallen several percentage points, and are well below their December 1980 levels. The question is why are long-term rates so high ? Why have rates not responded sooner to the progress made in fighting inflation and bringing monetary growth under control? As Noble Laureate Milton Friedman pointed out in Newsweek magazine, there are many possible explanations, none of which is entirely satisfying.

The most common response to this question, one that is heard in the financial community, is that rates are high because market participants fear that heavy deficit financing now and in the future will keep financial markets tight for a long time.

Whether or not Professor Friedman is correct, the very fact that deficits are believed by so many in the financial markets to cause high rates makes this view important. In a sense it has all the aspects of a self-fulfilling prophecy. High real rates dampen economic activity and reduce revenue at the same time they add to the cost of carrying the national debt and thus increase the deficit. Therefore, to reduce interest rates, it is important that the Administration and Congress convince the public that we will continue to make credible progress toward reducing the deficit.

Another commonly heard explanation for high interest rates is the belief that the improvement in inflation is only transitory. According to this view, despite the Administration's program and current Federal Reserve policy, there has been no lasting change in policy objectives and responses; money growth will soon turn expansionary again in the pursuit of short-run economic goals. Thus, if we are going to get a reduction in interest rates, it is essential that we convince these skeptics that there indeed has been a change in policy and that we are committed to an anti-inflation program for the long haul. The worst thing we could do would be to abandon monetary restraint, even in the short run. The financial markets would interpret this as a surrender to inflation and the inflation premium in nominal interest rates would leap upward as it did in the summer and fall of 1980.

The concerns of financial market participants should be viewed with the perspective of the last twenty years in mind. In 1961, short-term interest rates, such as on Treasury bills, were less than 2-1/2 percent and inflation was only about 1 percent. Inflation and interest rates increased sharply over the next five years, resulting in the first "credit crunch" in 1966. At that time, three-months Treasury bill yields reached the unprecedent high level of 5-1/2 percent.

In the fifteen years since then there have been three more credit cycles, each one resulting in more severe financial strains than the previous one. The peak levels of short-term interest rates in the "credit crunches" of 1969-70, 1974 and 1980-81, in each case, have been nearly 50 percent above the peak levels of the previous cycle. When rates subsequently declined, they did not decline as low as the previous cycle before starting to rise to new high levels .

Participants in financial markets are very familiar with this historical pattern and are fearful it will be repeated again. At least they are not willing to bet against it happening again. If one were to extrapolate from the past twenty years out over the next few years, the safest assumption to make is that short-term interest rates will reach a new peak once again, in the next three to five years, at about 50 percent above the levels reached in 1980-81. That would mean short-term interest rates of about 30 percent.

This Administration is determined to break that historical pattern and make certain that the 1980s is a decade of declining inflation and interest rates. But all we can do is propose policies. The Congress and the Federal Reserve implement fiscal and monetary policies, and the objectives of this Administration will be achieved only if there is full coordination and cooperation between the Administration, the Congress, and the Federal Reserve.

While we expect interest rates to fall, real rates in the 1980s may be more in line with our experience in the 1960s rather than that of the 1970s. During the 1970s the poor climate for investment produced by bad government policy, and rising energy prices, kept real rates of return very low, if not negative. The tax policies that this Administration and Congress have already enacted, coupled with our cost-benefit approach to regulation, will raise the return from productive investment and increase the demand for funds. Since the tax incentives for investment are front-loaded in our progam, but the incentives to increase saving come into effect more gradually with the staged personal income tax cuts, high real rates may persist for a while longer. Yet nominal interest rates will fall as the inflation premium is reduced.

Looking Ahead

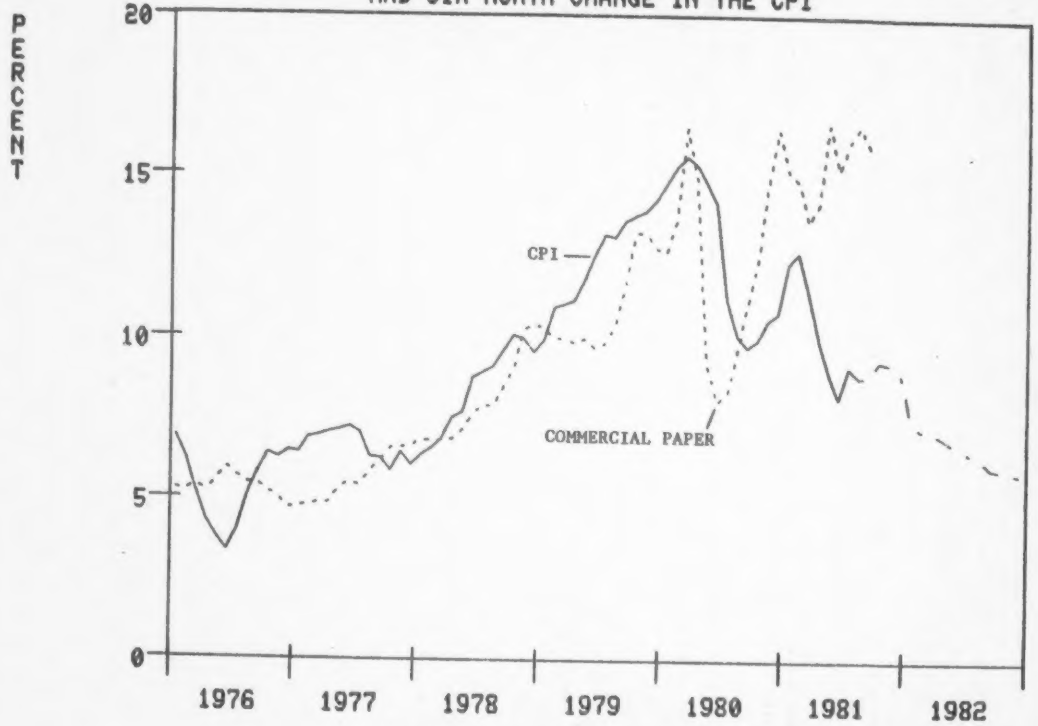
As I mentioned earlier, the third quarter was flat or slightly down. The fourth quarter is likely to be about the same. If the recent decline of interest rates continues and money growth remains at a moderate anti-inflationary rate, there is good reason to expect the beginning of a recovery in the first quarter of 1982. The deceleration in money growth from 1980 to 1981 has brought about a reduction of nominal income growth in 1981. As market participants fully understand that we will not back off from a slow and stable monetary policy, inflation and interest rates will decline more quickly, thus paving the way for a sound expansion in real economic growth in 1982. This expansion will be greatly aided by the Administration's fiscal program now largely in place.

Because of the current high interest rates and the lags in responding to the Administration's program, real growth will probably be fairly modest during the first half of 1982. However, it would accelerate during the year with real activity showing some impressive gains in the second half. As for inflation, we continue to expect a year-over-year deceleration of between one and two percentage points compared with 1981.

The combination of slow and stable money growth and declining inflation rates means that the long-term outlook for nominal interest rates is for a sustained downward trend. It is impossible to predict exactly how rapidly this decline will occur, but by mid 1982, we should see both long-and short-term rates significantly below their current levels. This decline in rates will be beneficial to the housing market and automobile industry which will show sustained recovery from the current depressed levels over the next year.

In general, our economic forecast continues to reflect the responsible monetary and fiscal policy which has been advocated by this Administration and will be adhered to for the duration, despite any short-term reverses in the economic environment.

RATE ON SIX MONTH COMMERCIAL PAPER AND SIX MONTH CHANGE IN THE CPI



LATEST DATA AVAILABLE: CPI -- AUGUST, 1981
COMMERCIAL PAPER RATE -- SEPTEMBER, 1981
PROJECTION IS BASED ON MID-SESSION REVIEW

Chairman Domenici. We will now hear from Dr. Sprinkel, Under Secretary for Monetary Affairs, U.S. Department of the Treasury. Doctor, we are glad to have you here and we do have your statement, but you are free to handle it as you see fit.

Dr. Sprinkel?

STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Dr. Sprinkel. Thank you, Chairman Domenici and other distinguished members of the Budget Committee. I am pleased to have this opportunity to discuss monetary policy with you today. I will, Mr. Chairman, present an abridged version of my statement. Committee members have received copies of the complete statement, which I would also like to be included in the hearing record.

Chairman Domenici. It will be so included.[1]

Dr. Sprinkel. I will be happy to respond subsequently to any questions or comments the committee may have pertaining to my remarks here, to my full statement, or any related matter of concern.

ECONOMIC SITUATION ASSURES NO OVERNIGHT RESULTS

Today's sustained inflation and high interest rates are the legacy of the economic policy excesses of the past two decades. The level of interest rates and the conditions in the financial markets today are symptomatic of the longrun effect of Government actions which have caused accelerating inflation, rising tax rates, and proliferating regulations. In addition, the repeated failure of the Government to deliver on promises to reverse these trends has created an economic environment dominated by uncertainty and skepticism about the future and the ability of the Government to pursue effective economic policies.

I know that it is of small consolation to farmers, small businesses, or automobile dealers to explain that today's crushing interest rates are caused by past monetary and fiscal policy. The point is that the situation would be much worse without the actions which have been taken since this administration came into office. In particular, continued rapid money growth at the pace of the past several years would have produced higher, not lower, interest rates.

The economic situation from which we started assures that there are no overnight results. Bond buyers and the public in general must have confidence in the durability and direction of the new policies. Because of the repeated failures of the past, one of the tasks before us is to restore the credibility of announced Government policy. Unfortunately, but understandably, earning the public's confidence takes time and depends more on real, observed results than it does on rhetoric.

When the noninflationary policy and its direction become accepted and believed, uncertainty will decline and inflationary expectations will be reduced. This recognition would reduce the cost of the adjustment to a noninflationary economy. It facilitates lower interest rates. The economy can then shift onto a disinflationary course without the burden of high interest rates.

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[1] See p. 310.

We cannot wave magic wands, nor is yelling at the evils of high interest rates a remedy. It may be a temporary catharsis, but unfortunately it often leads to suggestions for shortrun policies that would make things worse. And the worst of these policies is a reversal, even if it is labeled a temporary deviation, of the steady, predictable reduction in the trend of monetary growth.

Given the history of stop-and-go monetary growth over the past two decades, accelerations of money growth carry the extreme danger of being interpreted as evidence of a lack of resolve, signaling yet another sporadic, hafl-hearted, and unsuccessful attempt to wind down money growth to noninflationary levels. Interest rates would go much higher and output would be further curtailed. We must stick to a longrun policy of keeping money growth at noninflationary levels.

MONETARY POLICY: THE SHORT RUN AND THE LONG RUN

In evaluating monetary policy, it is important to recognize that its immediate, shortrun effects are different from its ultimate longrun impact. The charts contained in my full statement illustrate these relationships.[1]

In the long run, the major impact of money growth is clearly on the price level. The longrun rate of inflation is closely related to the trend rate of money growth.

In the short run, however, deviations in money growth from its trend rate have had significant effects on output and employment. A rapid decline in shortrun money growth below its longrun trend rate has preceded each downturn in economic activity. In most cases, such as 1957, 1959, 1966, 1969, and 1980, abrupt monetary restriction was a primary cause of the decline in economic activity.

However, these few periods of decrease in money growth below its long-term growth path were too short to have had any real impact on the trend of money growth. Instead, money growth was soon reaccelerated and the trend rate of monetary expansion continued to rise.

Consequently, these brief episodes of monetary restraint had little effect on inflation. They were large enough to have immediate adverse effects on output and employment, but not long enough to have the desired beneficial effect on inflation. We suffered the immediate but temporary costs of recession, but threw away the prospect for lasting benefits; that is, less inflation.

We have had about 5 months of significantly slower money growth. It is naive to expect that this deceleration would have no temporary adverse effects on income, output, and employment.

The persistently rising trend of money growth over the past decade guarantees that in the short run, anti-inflationary monetary policy will affect output and employment more than it does inflation. This is the unavoidable shortrun cost of a successful anti-inflationary policy. The longrun effect of a sustained deceleration of money growth will be reduced inflation, but the crucial word is "sustained."

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[1] See pp. 313 and 314.

REDUCING INFLATION THROUGH MONETARY DISCIPLINE TOO EXPENSIVE

The mistake that has been made repeatedly in the past has been to reverse monetary restraint before its anti-inflationary benefits are realized. As soon as the short run costs of monetary deceleration were felt—the adverse effects on output and employment—money was reaccelerated in an attempt to offset or avoid these costs. Then, as now, prominent analysts contended that reducing inflation through monetary discipline is too expensive in terms of output, employment, and jobs. Contending that there are other less painful remedies, they continue to advise the Federal Reserve to ease monetary restraint.

Ironically, the costs of reducing inflation actually are increased by such stop-and-go policies. Expectations of permanently rapid money growth are reinforced, increasing the resistance of inflation to monetary control and aggravating the short-term costs of future efforts to impose monetary discipline. The costs are only delayed and made more severe the longer we procrastinate.

While the link between money and prices is long term, we will never reach the long term without taking the first step. A permanent reduction in money growth is absolutely necessary for reduction of inflation. The markets do not doubt this. Instead, they doubt that the current policy is, in fact, the first step in that direction. Officials of the Federal Reserve, however, continue to reaffirm their commitment to this policy and they have the total support of the administration. From our perspective, the proper course is a stable and moderate monetary growth; that is, neither monetary contraction if the economy weakens, nor soaring monetary growth.

In general, there have been two basic factors which have contributed to the lack of long-term monetary discipline in the past. The first was the efforts to use monetary policy to fine-tune the economy, as I have just discussed. The second was the monetization of budget deficits.

EFFECTS OF A BUDGET DEFICIT

For years, the Government has financed a proliferation of programs and regulations through inflation. The interaction of inflation and the progressive tax structure has generated ever-increasing revenues to finance growth of the Government sector, eliminating the need to seek unpopular tax increases or the explicit consent of the American people. Instead, workers and taxpayers have been made to pay and suffer by means of bracket creep and the direct tax of inflation on both income and holdings of cash and other dollar denominated assets.

Financing larger and larger Government spending programs through inflation, while seemingly a painless policy in the short run, is a shortsighted policy that has had far-reaching, insidious effects on the U.S. economy. For inflation, while quietly filling the Government's revenue coffers, causes enormous distortions in the economy and erodes incentives for individuals to work, save, and invest.

When the Federal Government finances a deficit by selling debt securities, it adds to the demand for credit in the financial markets. A deficit, therefore, absorbs credit in the private financial markets—credit that would otherwise be available to private borrowers. Because Government borrowing increases competition for funds in the credit market, the real rate of interest—that is, the interest rate that would prevail if there were no inflation—is higher in the presence of a budget deficit than if there were no deficit.

These are the adverse economic effects of a budget deficit: it bids up real interest rates, takes credit away from private borrowers, reallocates resources from the private to the public sector, and thereby restricts economic growth. These effects are real and cannot be ignored.

At the same time, however, there are other relevant factors which deserve mention. While the deficit would be expected to put upward pressure on interest rates, the tax cut, as it is implemented, will help to ease these pressures. High tax rates encourage high nominal interest rates by reducing the effective, after-tax rate paid by the borrower as well as the after-tax rate of return earned by the lender. Lower tax rates will reduce the gap between what the borrower pays after taxes and what the lender earns after taxes, thereby facilitating lower rates.

Lower tax rates, as well as other incentives written into the tax bill, should encourage savings, which will increase the pool of real resources which are available to all potential borrowers. Increased credit availability should also help facilitate lower interest rates.

While these considerations do not eliminate the economic costs of budget deficits, they change considerably the effects of the extra Government borrowing which result from the administration economic program, relative to the deficits of prior years.

In addition, success in reducing inflation would, for a time, contribute to the deficit because the growth of nominal, but not real, income would be restrained. The immediate effect is a reduction in the growth of nominal tax revenue. With no change in growth of Government spending, the immediate deficit increases.

Perhaps the irony of this situation has not been driven home. The public demands, and we support, elimination of inflation. However, the Government must face the fact that it has been using inflation to finance the growth of Government spending. As inflation declines, the Government can no longer rely on the revenue which inflation generates, and the economic costs of ever-increasing Government spending will become much more evident.

I cannot emphasize strongly enough our concern that the beneficial effects of our program on incentives for work, saving and investment not be hindered by the prospect of budget deficits. The necessary sequel to the recent tax action is determined and persistent efforts to restrain Government spending. Significant steps have already been taken, but there is still much progress to be made.

DEFICITS AND MONETARY POLICY

The claim that a budget deficit necessarily interferes with monetary control is erroneous. Only if the Federal Reserve attempts to minimize or reverse the immediate upward pressure on interest rates that can accompany Treasury financing by purchasing the Government securities is monetary control effective. For example, if the Federal Reserve reacts to the upward pressure on interest rates caused by a deficit and monetizes the budget deficit, money growth increases. In this instance inflationary money growth is a byproduct of the deficit. The Federal Reserve cannot peg interest rates and simultaneously control the money supply.

There is, however, no technical or legal reason for the Federal Reserve to monetize budget deficits. In fact, the intent of the law is clearly the opposite, for it severely limits the amount of Government securities the Federal Reserve can buy directly from the Treasury.

It is always tempting to have the Federal Reserve monetize a deficit. Such a policy provides a means for covering up troublesome and unpopular increases in interest rates and temporarily reduces the cost to the Treasury of financing a deficit. The seemingly painless policy is a shortsighted one with serious, harmful, long-term effects.

A policy of monetizing the debt, designed to alleviate upward pressure or rises in interest rates, ignores the fact that increased money growth must accompany Federal Reserve purchases of Government debt. Such money growth generates inflation and inflationary expectations and leads ultimately to higher interest rates, not lower interest rates. The Reagan administration recognizes the connection among monetization of the deficit, money growth, and inflation, and neither expects nor desires that the Federal Reserve monetize its deficits.

REAGAN ECONOMIC PROGRAM COMMITTED TO LONGRUN POLICIES

The Reagan economic program does not seek cosmetic, shortrun relief for our economic ills. It is a longrun program designed to control inflation and provide for real economic growth. Unlike previous policies, it does not attempt to use a placebo for economic problems through expenditures the Nation cannot afford, and extract the cost later through inflation and unlegislated tax increases.

The excesses and mistakes of the past cannot be reversed in a few months. We, therefore, cannot expect overnight results. Years of inflation have had a powerful effect on the U.S. economy and psyche. It is reflected in wage contracts, pricing decisions, and saving behavior. It is also reflected in high interest rates.

Years of failure, despite programs, promises and the best of intentions to control inflation, have had a pervasive effect on the public's confidence in the ability and willingness of the Federal Government to pursue effective anti-inflationary and economic growth policies. That uncertainty, not deeply engrained, is reflected in the continuation of high interest rates. Public skepticism also prolongs the period of time before the new policies will have the desired beneficial effect on inflation, interest rates, and economic growth.

Equivocation, however, is not the answer. Returning, even temporarily, to the mistaken policies of the past will only guarantee that the economic problems we now face will get worse.

For example, those who call for an easing of monetary policy to lower interest rates fail to recognize the full costs that returning to faster money growth would entail. Higher inflation rates, higher interest rates, and higher unemployment rates are the certain results. Equivocation would further erode public confidence and reduce the effectiveness of economic policy.

We are returning the American economy to a path of noninflationary real growth and low interest rates. This administration is committed to the consistent pursuit of the longrun policies that will keep us on that path. With the continued support of the Congress and the American people, we will succeed.

Thank you, sir.

Chairman DOMENICI. Thank you very much.

PREPARED STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Chairman Domenici, Senator Hollings, and distinguished members of the Budget Committee, I am pleased to have this opportunity to discuss monetary policy with you today.

No Overnight Results

Today's sustained inflation and high interest rates are the legacy of the economic policy excesses of the past two decades. The level of interest rates and the conditions in the financial markets today are symptomatic of the long-run effects of government actions which have caused accelerating inflation, rising tax rates, and proliferating regulations. In addition, the repeated failure of the Government to deliver on promises to reverse these trends has created an economic environment dominated by uncertainty and skepticism about the future and the ability of the Government to pursue effective economic policies.

I know that it is of small consolation to a farmer, small business person, or automobile dealer to explain that today's crushing interest rates are caused by past monetary and fiscal policies. The point is that the situation would be much worse without the actions which have been taken since this Administration came into office. In particular, continued rapid money growth, at the pace of the past several years, would have produced higher, not lower, interest rates.

The economic situation from which we started assures that there are no overnight results. Bond buyers and the public in general must have confidence in the durability and direction of the new policy. Because of the repeated failures of the past, one of the tasks before us is to restore the credibility of announced government policies. Unfortunately, but understandably, earning the public's confidence takes time, and depends more on real, observed results than it does on rhetoric.

When the non-inflationary policy and its direction become accepted and believed, uncertainty will decline, and inflationary expectations will be reduced. This reduces the cost of the adjustment to a non-inflationary economy. It facilitates lower interest rates. The economy can then shift onto a disinflationary course without the burden of high interest rates.

We can't wave magic wands. Nor is yelling at the evils of high interest rates a remedy; it may be a temporary catharsis but, unfortunately, it often leads to suggestions for short-run policies that would make things worse. And the worst of these policies is a reversal -- even if it is labelled a "temporary deviation" -- of the steady, predictable reduction in the trend of monetary growth.

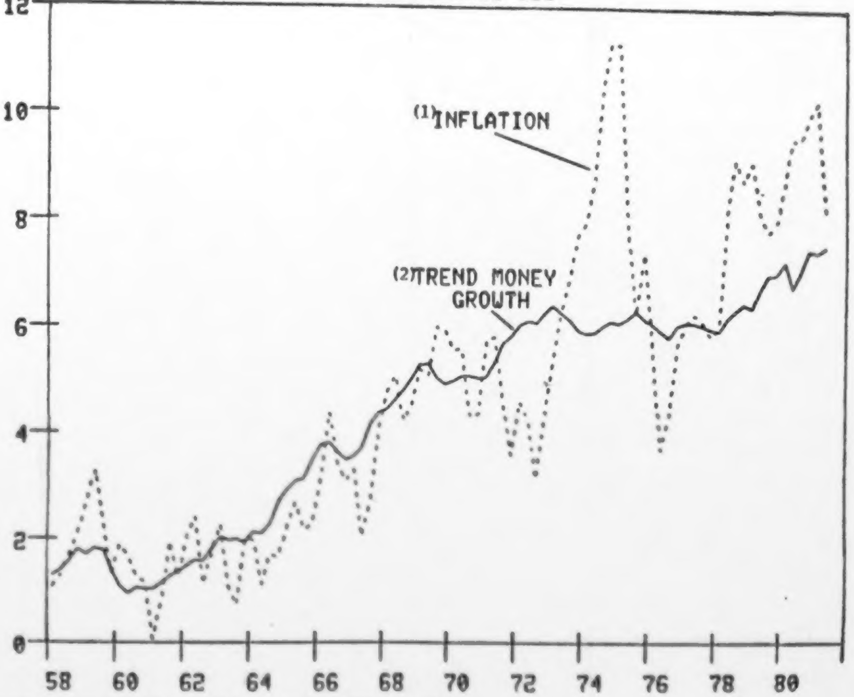
Given the history of stop-and-go monetary growth over the past two decades, accelerations of money growth carry the extreme danger of being interpreted as evidence of a lack of resolve, signalling yet another sporadic and unsuccessful attempt to wind down money growth to non-inflationary levels. Interest rates would go much higher and output would be further curtailed. We must stick to a long-run policy of keeping money growth at non-inflationary levels.

Monetary Policy: The Short Run and the Long Run

In evaluating monetary policy, it is important to recognize that its immediate, short-run effects are different from its ultimate, long-run impact. In the long run, the major impact of money growth is on the price level. In the short run, however, deviations in money growth from its trend rate have had significant effects on output and employment. Chart 1 shows the fairly close relationship between the trend in money growth and the long-run rate of inflation. Except for the recorded decline in inflation in the 1971-2 period (which can be traced to the temporary effects of wage-price controls) and the acceleration of inflation in

CHART 1

MONEY GROWTH AND INFLATION
1958 TO 1981 QII

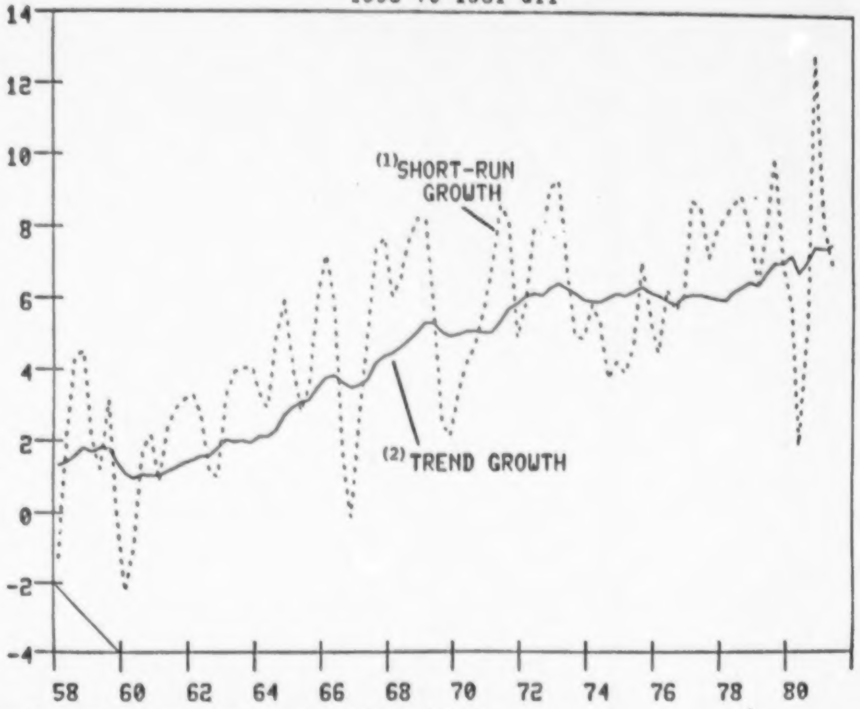


(1) Inflation is the 2-quarter annual rate of change in the GNP deflator.

(2) Trend growth of money is the 20-quarter annual rate of change in M1B.

CHART 2

MONEY GROWTH RATES
1958 TO 1981 QII



(1) Short-run money growth is the 2-quarter annual rate of change in M1B.

(2) Trend growth of money is the 20-quarter annual rate of change in M1B.

1973-4 (a result of the oil-price shock and the inevitable catch-up in prices which accompanied decontrol) the rate of inflation follows the long-run trend of money growth.

Chart 2 shows both the short-run (averaged over 2 quarters) rate of money growth and its long-run growth rate (averaged over 20 quarters). A rapid decline in short-run money growth, below its long-run trend rate, has preceded each downturn in economic activity. In most cases, such as in 1957, 1959, 1966, 1969, and 1980, abrupt monetary restriction was the primary cause of the decline in economic activity. In 1974, however, the recession was generated by the massive and unexpected increase in oil prices which followed the embargo. Reduction of money growth might have exacerbated the decline later in 1974, but it certainly was not the dominant factor. The rapid decline in money growth in 1980 was very short-lived, but it also contributed to a sharp, though short-lived, decline in the economy.

These few periods of decreases in money growth below its long-term growth path were too short to have had any real impact on the trend of money growth. Instead, money growth was soon reaccelerated and the trend rate continued to rise. Consequently, these brief episodes of monetary restraint had little effect on inflation. They were large enough to have immediate, adverse effects on output and employment, but not long enough to have the desired, beneficial effect on inflation.

These charts are intended to illustrate the interaction of monetary policy and public expectations. The trend rate of money growth has a significant effect on the expected rate of future money growth and of inflation. Since the trend of money growth has risen steadily for over a decade, the financial markets and the public in general now are understandably reluctant to accept assurances that the trend will be decreased. This skepticism reinforces the expectation that the rate of inflation will continue along its path of acceleration. The task is to attack that skepticism and to break the expectation that inflation will continue.

We have had about five months of significantly slower money growth. It is naive to expect this deceleration would have no temporary adverse effects on income, output and employment. The persistently rising trend of money growth over the past decade guarantees that, in the short run, anti-inflationary monetary policy will affect output and employment more than it does inflation. This is the unavoidable, short-run cost of a successful anti-inflationary policy. The long-run effect of a sustained deceleration of money growth will be reduced inflation. But the crucial word is "sustained."

The mistake that has been made repeatedly in the past has been to reverse monetary restraint before its anti-inflationary benefits are realized. As soon as the short-run costs of monetary deceleration were felt -- the adverse effects on output and employment -- money was reaccelerated in an attempt to offset or avoid these costs. Then, as now, prominent analysts contended that reducing inflation through monetary discipline is too expensive, in terms of output, employment and jobs. Contending that there are other, less painful remedies, they advise the Federal Reserve to ease the monetary restraint.

Ironically, the short-run costs of monetary discipline actually are increased by such stop-and-go policies. Expectations of permanently rapid money growth are reinforced, increasing the resistance of inflation to monetary control and aggravating the short-term costs of future efforts to reduce the trend of money growth. The costs are only delayed, and made more severe, the longer we procrastinate.

The record of a persistently rising trend of money growth and inflation, punctuated by transient and unsuccessful efforts to decelerate money growth, has produced a powerful new psychological force in the economy. That force is uncertainty about the resolve and the ability of the government to pursue a noninflationary policy. Such skepticism helps maintain the momentum of inflation and prolongs the period of time that the painful output effects are the dominant effect of monetary deceleration.

While the link between money and prices is long term, we will never reach the long term without taking the first step. A permanent reduction in money growth is absolutely necessary for reduction of inflation. The markets do not doubt this. Instead, they doubt that the current policy is, in fact, the first step in that direction. Officials of the Federal Reserve continue, however, to reaffirm their commitment to this policy and they have the total support of the of the Administration.

In general, there have been two basic factors which have contributed to the lack of long-term monetary discipline. The first is the efforts to use monetary policy to fine tune the economy, as is illustrated in the charts which I have presented. The second is the monetization of budget deficits. Neither we, nor the Federal Reserve, intend to respond to these pressures in the future.

Effects of a Budget Deficit

For years we have financed a proliferation of government programs and regulations through inflation. The interaction of inflation and the progressive tax structure has generated ever-increasing revenues to finance a larger and larger government sector, without the need for unpopular tax increases or the consent of the American people. Through bracket creep, and the direct tax of inflation on income and cash holdings, workers and taxpayers have suffered.

Financing larger and larger government spending through inflation, while seemingly a painless policy in the short run, is a short-sighted policy that has had far-reaching, insidious effects on the U.S. economy. For inflation, while quietly filling the government's revenue coffers, causes enormous distortions in the economy and erodes incentives for individuals to work, save and invest.

When the Federal government finances a deficit by selling debt securities, it adds to the demand for credit in the financial markets. A deficit, therefore, absorbs credit in the private financial markets, credit that could otherwise be available to private borrowers. It transfers to the public sector financial resources from the private sector, from businesses that would borrow for capital investment, from households that would borrow to buy a house. In this respect, deficits are similar to direct taxation, facilitating the growth of the government sector, at the expense of the private sector.

Because government borrowing increases competition for funds in the credit markets, the real rate of interest -- the interest rate that would prevail if there were no inflation -- is higher in the presence of a budget deficit than if there were no deficit.

These are the adverse economic effects of a budget deficit: it bids up real interest rates, takes credit funds away from private borrowers, and reallocates resources from the private to the public sector and thereby restricts economic growth. These effects are real and cannot be ignored. At the same time, however, there are other relevant factors which deserve mention.

While the deficit would be expected to put upward pressure on interest rates, the tax cut, as it is implemented, will help to ease these pressures. High tax rates encourage high nominal interest rates by reducing the effective, after-tax rate paid by the borrower as well as the after-tax rate of return earned by the lender. Lower tax rates will reduce the gap between what the borrower pays (after taxes) and what the lender earns (after taxes), thereby facilitating lower rates.

Lower tax rates, as well as other incentives written into the tax bill, should encourage savings, which will increase the pool of funds available to all borrowers in the financial markets. Increased credit availability should also help facilitate lower interest rates. While these considerations do not eliminate the economic costs of budget deficits, they change considerably the effects of the extra government borrowing which result from the economic program, relative to the deficits of prior years.

In addition, success in reducing inflation would, for a time, contribute to the deficit, because the growth of nominal (but not real) income would be restrained. The immediate effect is a reduction in the growth of nominal tax revenue. With no change in growth of government spending, the immediate deficit increases. Perhaps the irony of this situation has not been driven home. The public demands elimination of inflation, and the Government must face the fact that it has been using inflation to finance the growth of government spending. As inflation declines, the Government can no longer rely on the automatic revenue increases that inflation generates, and the economic costs of ever-increasing government spending will become much more evident.

I cannot emphasize strongly enough our concern that the beneficial effects of our program on incentives for work, saving and investment not be hindered by the prospect of budget deficits. The necessary sequel to the recent tax action is determined and persistent efforts to restrain government spending. Significant steps have already been taken, but there is still much progress to be made.

Deficits and Monetary Policy

The claim that a budget deficit necessarily interferes with monetary control is erroneous. Only if the Federal Reserve attempts to minimize or reverse the immediate upward pressure on interest rates that can accompany Treasury financing by purchasing the government securities is monetary control affected. For example, if the Federal Reserve reacts to the upward pressure on interest rates caused by a deficit, and "monetizes" the budget deficit, money growth increases. Inflationary money growth is then a by-product of the deficit. The Federal Reserve cannot control or peg interest rates and simultaneously control the money supply.

There is, however, no technical or legal reason for the Federal Reserve to monetize budget deficits. In fact, the intent of the law is clearly the opposite, for it severely limits the amount of government securities the Federal Reserve can buy directly from the Treasury.

It is always tempting to have the Federal Reserve monetize a deficit. Such a policy provides a means for covering up troublesome and unpopular increases in interest rates and temporarily reduces the cost to the Treasury of financing a deficit. This seemingly painless policy is a short-sighted one with serious, harmful long-term effects.

A policy of monetizing the debt, designed to alleviate upward pressure or rises in interest rates, ignores the fact that increased money growth must accompany Federal Reserve purchases of government debt. Such money growth generates inflation and inflationary expectations, and leads ultimately to higher interest rates, not lower interest rates. The Reagan Administration recognizes the connection among monetization of the deficit, money growth, and inflation, and neither expects nor desires that the Federal Reserve monetize its deficits.

When the Federal Reserve implemented open-market operations with the aim of controlling interest rates, the Federal Reserve's own operating procedures frequently called for it to monetize government debt. If the financing of a deficit pushed interest rates above the Federal Reserve's narrowly-prescribed range, purchases of securities were called for to bring rates back within their target range.

A deficit does not necessarily reduce the ability of the Federal Reserve to control money growth. Deficits complicate monetary control only when the monetary authority reacts to short-term movements in interest rates.

With Federal Reserve policy now focused on the control of bank reserves and with recognition within the Administration of the inflationary effect of monetizing the debt, there is no reason to sacrifice monetary targets in order to control interest rates.

Deficits and Inflation

When the Government borrows to finance a deficit, it acquires money from the purchasers of securities and then returns the money to the public when it pays for the deficit expenditures. Money changes ownership, but there is no change in the money stock, as long as the Federal Reserve does not monetize the debt. Government borrowing to finance a deficit, therefore, represents an increase in the demand for credit, but the supply of money need not increase.

Financing a deficit is a credit market phenomenon, not a monetary problem. The negative effects of government borrowing originate in the credit markets -- crowding out private investment and restricting economic growth. For a given rate of monetary expansion, less growth in the economy means more inflation. In this sense, budget deficits are inflationary. Cutting the deficit, however, is a complement, not a substitute for effective monetary control in reducing inflation. While a budget deficit can add to long-term inflationary pressure, its effect on inflation is small compared to that of excessive money growth. Inflation cannot be reduced from the double-digit rates of recent years without a deceleration of money growth to a noninflationary pace.

The notion that a tighter fiscal policy could be substituted for monetary control in fighting inflation in the short run is not supported by the evidence. In particular, it is informative to look back to fiscal year 1969, the only time in over twenty years when we have achieved a budget surplus. Taxes were raised with the explicit intention of restricting inflation, while reducing interest rates. As the table below shows, the budget shifted from a deficit of $25 billion to a surplus of $3 billion. Unfortunately, however, inflation and interest rates rose. Why? The primary reason is that money growth, which had accelerated sharply early in 1967, continued to rise excessively through 1968. Interest rates and prices reflected the reality of inflationary monetary actions. This monetary effect overwhelmed the effect of the reduced deficit on credit markets.

	Budget	% Change in Prices		Change in Interest Rates:	
Fiscal Year	Deficit (-) Surplus (+)	CPI	GNP Deflator	4-6 Month Commercial Paper	Corp Aaa
1968	-$25.2b	4.1%	4.3%	+136	+ 99
1969	3.3	5.5%	4.6%	+146	+ 64
1970	-2.8	6.0%	5.6%	+ 63	+125
1971	-23.0	4.4%	5.2%	-312	- 67

Summary

The Reagan economic program does not seek a cosmetic, short-run relief to our economic ills. It is a long-run program designed to control inflation and provide for real economic growth. Unlike previous policies, it does not attempt to use a placebo for economic problems, through expenditures the nation cannot afford, and extract the cost later through inflation and unlegislated tax increases.

The excesses and mistakes of the past cannot be reversed in a few months. We therefore cannot expect overnight results. Years of inflation have had a powerful effect on the U.S. economy and psyche. It is reflected in wage contracts, pricing decisions and saving behavior. It is also reflected in high interest rates.

Years of failure, despite programs, promises and the best of intentions to control inflation, have had a pervasive effect on the public's confidence in the ability and willingness of the Federal government to pursue effective anti-inflationary and economic growth policies. That uncertainty, now deeply ingrained, is reflected in the continuation of high interest rates. Public skepticism also prolongs the period of time before the new policies will have the desired, beneficial impact on inflation, interest rates and economic growth.

Equivocation, however, is not the answer. Returning, even temporarily, to the mistaken policies of the past will only guarantee that the economic problems we now face will get worse. For example, those who call for an easing of monetary policy to lower interest rates fail to recognize the full costs that returning to faster money growth would entail. Higher inflation rates, higher interest rates and high unemployment rates are the certain results. Equivocation would further erode public confidence and reduce the effectiveness of economic policy.

We are returning the American economy to a path of non-inflationary real growth. This Administration is committed to the consistent pursuit of the long-run policies that will keep us on that path. With the continued support of the Congress and the American people, we will succeed.

Chairman DOMENICI. We will now proceed with Mr. Kudlow's testimony. The same holds for you in terms of your statement and the time you want to take. We will make your statement a part of the record. You can proceed as you see fit.

STATEMENT OF LAWRENCE A. KUDLOW, ASSISTANT DIRECTOR FOR ECONOMIC POLICY, OFFICE OF MANAGEMENT AND BUDGET

Mr. KUDLOW. Thank you, Mr. Chairman. I would prefer to summarize the statement, if I may, and include the statement as well as the accompanying appendix for the record.[1]

As I believe Jerry Jordan pointed out, 1981 has witnessed an important decline in the rate of inflation and, on that front, I think the administration can take at least some credit—perhaps not all, but some.

DISAPPOINTING YEAR FOR INTEREST RATES

Regrettably, however, the reduction in the inflation rate this year has not been accompanied by any substantial reduction in interest rates. Indeed, as we all observe, this has been a particularly disappointing year on the interest rate front.

Short-term rates for the week ended October 16 are somewhat below their levels of the beginning of the year. The 3-month bill rate is perhaps 1 percentage point below its January level.

However, current medium- and long-term rates are substantially above their January levels. The 10-year and 30-year Government bond rates have both risen about 260 basis points. The latest quotes put them at about 14.5 percent, which is not a record high, but quite close.

I would like to point out that the interest rate situation, which tends to take a short-term focus, is really not a short-term issue anymore. The U.S. economy has been living with high rates for quite some time.

Since the beginning of 1980, roughly 21 months, short-term rates have been moving sideways, at around 14 to 15 percent—after adjusting for the credit control shock of 1980. Long-term rates during that time have moved steadily higher. Again, I am adjusting out the credit control shock which caused a momentary and abrupt decline in rates. It is no wonder that the economy is in a weakened position with the persistence of high interest rates.

DECLINE IN MONEY GROWTH RATE

During 1981, the rate of money growth has declined from the 1980 rates. In fact, we have had good luck with money growth this year, which has fallen from the high and inflationary pace of the last several years.

The most widely followed aggregate, M_{1B}, has been running about 5 percent through the first 9 months of the year, and that is a good improvement from the 7 or 8 percent growth of the previous several years.

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[1] See p. 332.

However, the decline in money growth has not brought with it a reduction in medium- and long-term interest rates which have very important effects on the economy. My own view on this is that markets are concerned that the future inflation rate will not continue along a downward track. The principal reason for this continued skepticism over future inflation is the current position of the U.S. budget, coming in the wake of a period of considerable, unsustainable expansion of Federal spending.

The market has generated considerable doubt and skepticism over the ability of Congress and the administration to hold down spending. Interest rates themselves seem to reflect this pessimism. In fact, interest rates have become almost a metaphor of the economy; whereas in past years we have focused on unemployment and inflation, and we will continue to do so, interest rates are now front page news. And interest rates are sending us a very pessimistic message.

I think markets are rational and are commenting on past fiscal trends which have been deteriorating since the mid-1960's. In my testimony, I point out that budget outlays which grew for 15 years at a rate of less than 7 percent, exploded in the 1970's to nearly an 11 percent rate of growth. In recent years, that rate of increase has run on average about 14 percent.

Deficits have become permanent, and in recent years permanent deficits have become permanently higher deficits. The numbers are expanding even more if we include off-budget items.

DEFICIT, INFLATION, AND INTEREST RATE TRENDS

The linkage between deficits, interest rates and inflation may not be theoretically perfect; I will certainly concede that point. But I will point out that the evidence regarding deficit, inflation, and interest rate trends is impressive.

The GNP price deflator averaged about a 2.5-percent rate of growth from the mid-1950's through the late 1960's—a period when budget deficits were generally low. On average, inflation since then has increased substantially, running at almost 7 percent in the 1970's, and rising in recent years to about 9 or 10 percent. This mirrors the movement in budget deficits and Government spending.

Interest rates have proceeded along the same path. Interest rates were relatively low and stable in the 1950's and 1960's, and have increased substantially in the 1970's, reaching almost permanently high plateaus in the late 1970's and early 1980's.

DEFICITS

I think the deficit story, which in itself is enough, is still only part of the story explaining the problem of financial market pessimism and this pervasive inflationary attitude which is so difficult to break. The problem is also related to the new surge in Federal credit and lending activity we have observed in recent years.

It is not only the direct Treasury borrowing to finance the on-budget and off-budget deficit; it is also the explosion of loan guarantees, some of which are easily turned into budget outlays. Though they are not reported budget outlays, they are outlays, nonetheless, through the mechanism of the Federal Financing Bank.

Government-sponsored enterprises, under the umbrella of the Federal Government, are financing debt issues.

The numbers here are really quite stark, and I wish to draw them to your attention briefly. In 1980, the budget deficit was $70.5 billion. However, if we include guaranteed loans and Government-assisted agencies, which are both financed in the open market, we have to tack on another $53.8 billion in Government borrowing and credit demand. When added to the 1980 deficit, this yields $124.4 billion in total Federal credit demand, or total credit demand raised directly under Federal aegis.

By the Office of Management and Budget's reckoning, this borrowing consumed or absorbed about 36 percent of U.S. capital market activity in 1980, and the numbers for 1981 are worse. In 1981, direct borrowing will be about $79.3 billion. If loan guarantees and Government-sponsored enterprises are included, the Federal Government will take in about $154 billion from U.S. capital markets and will have absorbed, by our preliminary estimates, over 50 percent of the nonfinancial funds raised in the capital markets in fiscal 1981.

Analysis of the Federal budget tends to focus on deficits and they certainly are an important ingredient disrupting financial markets and elevating of interest rates.

But deficits are only part of the problem, and we are now talking in terms of the U.S. Government absorbing about 50 percent of financial market activity. This explosion in Government credit is particularly dangerous with respect to its implications for long-term economic patterns.

Both Congress and the administration desire an economic recovery as quickly as possible. Yet, with Government absorbing this volume of valuable savings and capital, prospects for economic recovery are, in my judgment, not good.

Chairman **DOMENICI**. Mr. Kudlow, I apologize. Would you go back, if you can, in your mind for the last minute and repeat the statement about deficits?

Mr. **KUDLOW**. Yes.

Chairman **DOMENICI**. I did not get it for some reason. [Laughter.]

Mr. **KUDLOW**. Yes; I am happy to. My contention is that Government deficits are bad enough in themselves, disrupting financial markets creating inflationary expectations and generating higher interest rates.

GOVERNMENT BORROWING

But my chief point, Mr. Chairman, in this regard is that in addition to the growth of Government deficits, we have experienced an explosive growth in numerous forms of Federal borrowing, credit, and lending activity.

In fiscal 1980, we estimate direct Treasury borrowings ran at about $70.5 billion. But if we include loan guarantees and if we include Government-sponsored enterprises which are raised in the open market under the umbrella of the Federal Government, we have to tack on another $54 billion. That brings the total Government borrowing burden, which impacts financial interest rates and expectations and the business community's expectations—the total burden jumps to $124.4 billion.

Based on our estimates, Federal credit absorbs about 36 percent of capital market activity raised by nonfinancial corporations in fiscal 1980. In 1981, the numbers are worse. The direct Treasury borrowing is going to run about $83 billion, by our preliminary estimates adding the further expansion of loan guarantees and federally sponsored debt, a staggering $155 billion worth of Federal paper has come onto the market in one form or another, and that runs over 50 percent of capital market funds raised by nonfinancial corporations.

If we can agree that deficits matter, have generated upward interest rate pressures, and have caused some economic deterioration, then we ought to agree that the entire picture of Government borrowing is even bleaker.

Expectations continue to be pessimistic, as people in the business and financial communities observe that Federal lending activity goes on almost unabated. Moreover, as the Government continues to crowd out and preempt legitimate private borrowing, keeping interest rates high and reversing all of the risk arrangements inherent in a well-functioning, efficient free market situation, we see that real resources are being drained from the private sector. Real resources are not flowing where the returns would necessarily be highest, and economic growth is suffering across the board.

Now, in the table in my prepared statement,[1] I have briefly noted some of these trends. Using this concept of Federal and federally assisted borrowing, we can see how the average volume has exploded from $10 billion in the 1955–69 period to $58 billion in the 1970's. In 1980 the volume had risen to $125 billion, and in 1981 to $155 billion.

The absorption rate has soared from 17 percent to 43 percent. This has been associated with a rise in both short- and long-term interest rates, inflation rates, the unemployment rate, and a decline in economic performance.

So, I invite your attention to these relationships, and I would also suggest that this broader view of Federal lending and borrowing is an important adjunct to the more normal credit market and economic analysis.

The Office of Management and Budget has conducted extensive statistical testing in recent months to quantify the effects of this Federal lending and credit activity on interest rates, real GNP growth, and monetary policy.

Our work, Mr. Chairman, is not yet complete, but I have presented for you information, review and comment in an appendix to my testimony so that we can work together in understanding the fuller implication of this Federal borrowing phenomenon which has exploded and seems to go on unabated.

FINANCIAL ATTITUDES ARE SKEPTICAL AND PESSIMISTIC

Finally, let me repeat that financial attitudes are skeptical and pessimistic. The legacy of policy errors and broken promises, weighs heavily on the Reagan administration and on the Congress in 1981.

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[1] See p. 339.

Long-term interest rates continue to adjust upward, despite the fact that we have had improvement in monetary policy and conditions. I believe the source of this upward adjustment in long-term rates is that, thus far, markets do not believe that Government possesses the will and the discipline to permanently contain budget growth, Federal borrowing and Federal lending in all of its many forms.

Although much improvement has been made on the fiscal scene—and the Omnibus Reconciliation Act of 1981 represents a major step in the right direction—the message we are getting from the business and financial communities right now is that we have not yet gone far enough.

As you know, the President has requested in his September budget package additional steps in the direction of budgetary and fiscal restraints. And as you know, there is considerable discussion going on in Congress and the administration to try to reach some agreement with respect to the need for additional concrete steps toward budget restraint.

Unless additional concrete steps are taken, and unless they are taken this fall, the attitudes of pessimism and skepticism coming in the wake of the data that I have presented to the committee this morning will grow worse until the markets see new, concrete steps. Saying so, Mr. Chairman, will not make it so. The markets want results and they want to see the results. My suggestion is that we move ahead as quickly as possible to bring interest rates down and to move us from economic recession to economic recovery.

That is all I have. Thank you.

Chairman DOMENICI. Thank you very much. Your statement will be made a part of the record.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

STATEMENT OF
LAWRENCE A. KUDLOW
ASSISTANT DIRECTOR FOR ECONOMIC POLICY
OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the effect of budget deficits and overall Federal credit activity on financial markets and interest rates.

During the first nine months of this year significant progress has been made in reducing inflationary pressures, with the rate of rise of consumer and producer price indexes falling by 2.4 and 6.5 percentage points, respectively, from last year's performance. Despite this success, 1981 has been a disappointment on the interest rate front. Prevailing yields on medium and long-term government securities are substantially above the levels reached last January. Short-term rates currently stand somewhat below their early January levels, although quite high by historic standards.

Selected Interest Rates

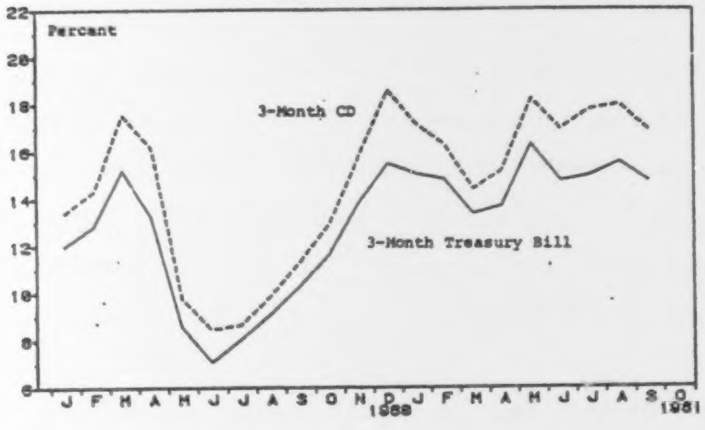
Week Ended Friday	3-mo T-Bill	5-year Gov't Note	10-year Gov't Bond	30-year Gov't Bond
Jan. 9, 1981	14.3	12.5	12.3	11.8
Oct. 16, 1981	13.4	15.1	14.9	14.4
Net change	-0.9	+2.6	+2.6	+2.6

On balance since January 3-month Treasury bills have declined by 0.9 percentage points, but most of this decline has occurred during the past 6 weeks. Longer-term yields, however, have increased by 260 basis points since the early part of the year, and this tightening in long-term markets has not been offset by the rate declines of recent weeks.

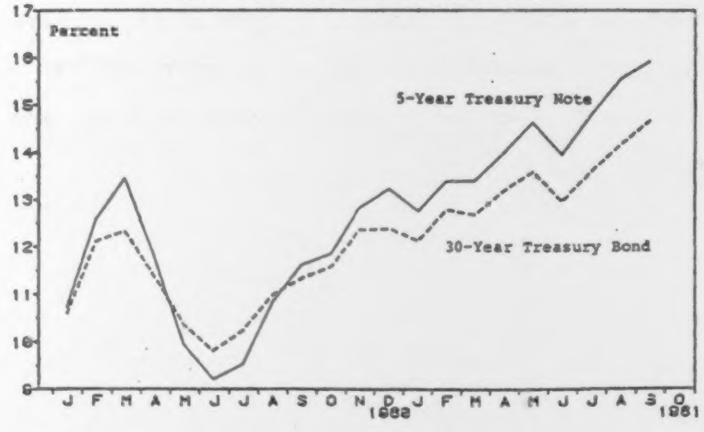
Looking back over the past 21 months, and adjusting for the interest rate collapse which accompanied last year's credit controls related recession, it can be seen that short rates have essentially moved sideways or slightly lower, while longer-term rates have trended substantially higher. In March of 1980 for example, the 3-month Treasury bill averaged 15.2%. In January 1981 the bill rate averaged 15.0%, and in September 1981 the bill rate averaged 14.7%. For the period as a whole there has been little change.

In contrast, the average yield on 30-year Treasury bonds registered 12.3% in March 1980, fell a bit to 12.1% in January 1981, and then jumped to 14.7% in September 1981. Thus, while the short rate has fluctuated around 15% for the better part of two years, the long rate has increased substantially.

3-MO T-BILL AND 3-MO CD RATES



5-YR T-NOTE AND 30-YR T-BOND RATES



As a footnote to the nearly continuous rise of long rates during the 1980-81 period, it is important to note that the rate of money growth during the first 9 months of 1981 has generally declined from the growth of money registered during 1980. From the fourth quarter of 1979 through the fourth quarter of 1980, the level of reported M1B increased by 7.2%. However, from Q4/80 through Q3/81, the annual rate of growth of M1B averaged 4.7%.

The broader aggregate M2 shows a smaller decline in growth. From Q4/79 through Q4/80 the level of M2 increased by 9.6%. Over the 3 quarters ended in September 1981, the annual rate of M2 growth registered 9.0%. The still broader aggregate M3 shows a slight increase in its growth, from 10.2% from the year ended December 1980 to 11.6% for the first 3 quarters of 1981.

Selected Rates of Money Growth
(SAAR)

	Q4/79 - Q4/80	Q4/80 - Q3/81
M1B	7.2	4.7
M2	9.6	9.0
M3	10.2	11.6

Netting out these results, it appears that monetary policy trends (in quantity terms) have tightened during the past year as compared with the year before. While there have been significant short-term fluctuations in money growth, the longer-term trend shows a pattern of deceleration. With this in mind, inflation expectations and interest rate conditions should have been improving in 1981 if based on actual money growth. Quite possibly, some of the rise in long rates may reflect a higher risk premium resulting from added market volatility. But the size of the increase in rates on longer term maturities seems instead to suggest that expectations of future inflation have intensified.

Since the current period of monetary restraint is unable to explain the rise in longer-term rates, then it seems reasonable to assume that the upward rate movement is a function of market anxieties over future monetary trends. And these fears are a logical outcome of the deteriorating U.S. budget position over a span of many years. During the past decade, budgetary discipline has eroded and the government's fiscal position has shifted deeper and deeper into the red. Deficits, once thought to be a stabilization tool during periods of slack, have become a permanent fixture regardless of the economy's position in the business cycle.

Despite some initial policy successes to overcome the trend of expanding deficits, there is widespread skepticism and doubt over the resolve of the government to continue on the course necessary to achieve the President's ambitious budget control objectives. The Administration has inherited an oppressive legacy of fiscal mismanagement and broken promises. This legacy, in turn, has generated a pervasive attitude of pessimism regarding expectations of future government spending and borrowing, future money growth and future inflation. Interest rates have become the economic metaphor of our time, and the continuous rise of most interest rates is a pessimistic expression that a better, non-inflationary future is not yet assured.

Drawing on the experience of recent years, financial markets are well aware of the trends of government spending and deficits.

	Budget Outlay Growth %	On-budget deficit	On- and off-Budget Deficit
1955-69	6.7	4.6	4.6
1970-79	10.7	30.2	35.0
1979	9.7	27.7	40.2
1980	17.3	59.6	73.8
1981 (e)	15.4	58.0	82.0

And the markets are also well aware of the linkage between deficits, inflation and interest rates.

	On-budget Deficit	GNP Deflator	20-year Gov't Bond
1955-69	4.6	2.5	4.2
1970-79	30.2	6.7	7.6
1979	27.7	8.5	9.3
1980	59.6	9.0	11.4
1981 (e)	58.0	9.6	13.6

But the steady rise of Federal deficits during the 1970's and early 1980's is only part of the story. Apart from the traditional borrowing to cover on- and off- budget commitments, in recent years a new surge of Federal credit demand has resulted from the proliferation of off-budget loan guarantees as well as direct lending by government-sponsored enterprises.

Direct borrowing by the Treasury in 1980 amounted to $70.5 billion (on- and off-budget), but guaranteed loans and government sponsored enterprise borrowing raised the overall credit demand under Federal auspices by another $53.8 billion, for a total of $124.4 billion of Federal borrowing. This borrowing absorbed 36% of all funds raised by the non-financial sector in 1980. In fiscal year 1981 the Federal absorption rate is estimated to rise to 43%. If the tax-exemption privilege is figured into the calculation, then the absorption rate of all funds raised for Federal and federally-assisted uses comes to 41% in 1981 and an estimated 50% in 1981.

The explosion of government and government-assisted credit has dwarfed the much discussed rise in deficits and has disrupted nearly all forms of economic and financial activity. Inflation expectations have intensified and interest rates have come under constant pressure. The disruption of financial markets has interfered with the conduct of monetary policy. The flow of private savings and capital has been preempted from the most efficient market directed uses. This government absorption of real resources has inhibited the growth of investment, real output and jobs. Market risk has been distorted and credit standards have been eroded. Inflationary pressures have been exacerbated.

The table below shows the direct relationship between the rise of Federal credit demand, the absorption rate, and the trend in both short- and long-term interest rates.

	Average Federal and Federally-Assisted Borrowing			
	Volume ($b)	Absorption Rate (%)	3-mo T bill (%)	20-yr T bond (%)
1955-1969	9.8	16.6	3.5	4.2
1970-1979	58.1	24.9	6.3	7.5
1980	124.4	35.5	11.4	11.4
1981	154.5 (e)	43.0 (e)	14.8 (thru Aug)	13.4 (thru Aug)

The relationship of overall Federal borrowing and interest rates, inflation and economic performance has been supported by extensive statistical testing by the Office of Management and Budget (see Appendix). With this broader view of Federal lending and borrowing, going beyond the traditional view of deficits, the acceleration of inflation, the escalation of interest rates and the decline in economic performance during the 1970's and early 1980's is more satisfactorily explained. But the markets have been concerned about this all along, and even a cursory examination of Federal credit demand and interest rates provides a clear pattern.

Financial markets over the years have become painfully aware of the full implication of persistent budget deficits and excessive Federal lending and credit activity. Intrusive and disruptive Federal borrowing has become a constant feature of the U.S. capital market scene. It is an oppressive legacy which has caused a shift in expectations of future inflation and future economic growth. The upward movement of medium and long-term interest rates in 1981 embodies this set of pessimistic assumptions. Of course, attitudes are always capable of change -- and steady implementation of the President's budget control plan this fall and the years ahead, would provide a long step in the right direction. But until markets are persuaded of a clean break from past policy errors and broken promises, longer-term interest rates are not likely to fall in any sustained fashion and economic recovery will remain an elusive goal.

I

Statistical Appendix

The disruptive effects of enlarged Federal credit demands can be demonstrated by the use of standard linear regression techniques. The results show that increased Federal borrowing raises interest rates and inflation and ultimately inhibits the growth of output. These effects occur largely, but not entirely, because increased Federal credit demands complicate and frustrate the conduct of monetary policy.

Previous work has shown that throughout most of the 1960's and 1970's, larger Federal deficits were accommodated by faster monetary growth.1/ It is not necessary, in theory, for such a relation to hold; indeed, there were intervals — such as 1975-76 — when the Federal Reserve was able to resist pressures to monetize deficits. But, in fact, over longer periods of time heavy Federal credit demands have always been accommodated to a certain extent.

Recent statistical analysis at the Office of Management and Budget confirms these findings. Moreover, the focus of the present work is not restricted to the traditional concept of the deficit but takes a broader view and considers the full range of Federal and federally-assisted borrowing. Specifically, the measure used in the regressional analysis is credit absorbed by the U.S. government and sponsored Federal agencies (e.g., FNMA), as reported in the Flow-of-Funds accounts.

1/ M.J. Hamburger and B. Zwick, "Deficits, Money and Inflation," Journal of Monetary Economics, January 1981.

II

To determine the impact of Federal credit demands on monetary growth, the following regression was fitted to annual data for the period 1958-1974.

$$\%\text{ ch M1B} = \underset{(0.29)}{0.28} + \underset{(3.40)}{0.54}\ \%\text{ ch M1B (T-1)} + \underset{(2.60)}{1.20}\ \text{(Credit/GNP)}$$

R bar sq = 0.54 DW Stat = 2.14 Std. error = 1.44

where the numbers in parentheses are t-statistics and

% ch M1B = the percent change in the M1B money stock

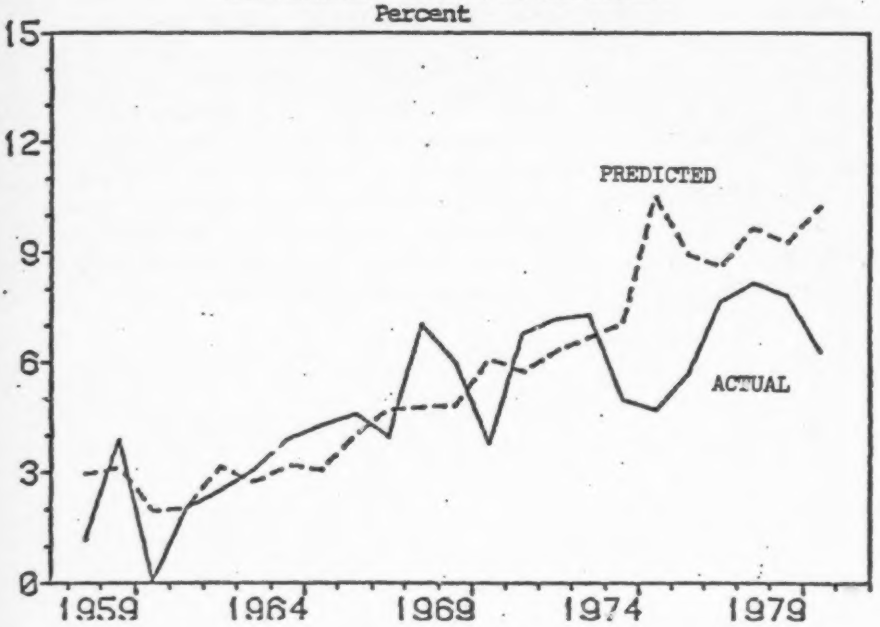
Credit/GNP = the amount of Federal credit absorption scaled (i.e., divided) by nominal GNP

The logic of this model is developed in the previously cited Hamburger-Zwick article. Both studies show that there is considerable inertia (or autoregressiveness) in money supply growth. This is illustrated by the presence of the lagged percent change in M1B growth on the right-hand side of the equation. More important for analytical purposes is the impact of Federal credit demands on money creation. The model suggests that a one percentage point increase in the (Credit/GNP) ratio would increase the growth in M1B by 1.2 percentage points. In 1981, a one percentage point increase in the (Credit/GNP) ratio would result from a $30 billion increase in Federal credit demands.

III

Since 1974, the Federal Reserve has shown a somewhat greater reluctance to monetize Federal credit demands. As shown in the chart below, the model consistently overpredicts M1B growth beginning in 1975. Despite this modification in Federal Reserve behavior, both money growth and inflation accelerated.

M1B GROWTH: ACTUAL VS PREDICTED
Percent



IV

If financial market participants are rational, and practically all available evidence suggests they are, the connection between Federal credit demands and money growth would not go unnoticed. Hence in forming expectations of future inflation, investors look at both observed money growth and Federal credit absorption, which provides an indication of future money growth. An analysis of long-term interest rates provides empirical support for these hypotheses.

It has become customary to view market interest rates as consisting of two basic components: a natural or real rate, which is influenced by the productivity of capital and varies little over time; and an inflation or price premium, which is a function of expectations of future inflation.

If the real rate is approximated by a constant, then fluctuations in long-term interest rates largely reflect variations in inflationary expectations. As the following regression equation indicates during the 1958-80 period, year-to-year movements in inflationary expectations depended about equally on three factors: (1) changes in the actual rate of inflation in the current and previous year; (2) the growth in M1B in the previous year; and (3) the current (Credit/GNP) ratio, i.e.

$$\begin{aligned} R = {} & \underset{(7.56)}{2.17} + \underset{(2.84)}{0.32}\ \%\ \text{ch M1B}\ (T-1) \\ & + \underset{(2.31)}{0.38} \left[.7\ \%\ \text{ch P}\ (T) + .3\ \%\ \text{ch P}\ (T-1) \right] \\ & + \underset{(1.98)}{0.33}\ (\text{Credit/GNP}) \end{aligned}$$

R-Bar Sq=0.93 DW Stat= 1.18 Std Error=0.57

Where

R: is the 20-year Treasury bond rate
P: is the GNP deflator

These results suggest that over the 1958-80 period, the real interest rate averaged about 2.2% and most of the observed movement in the 20-year bond rate was due to inflationary expectations. Perhaps even more important is the major role that Federal credit demands play in the formation of inflationary expectations.

V

The 1958-80 period is not an easy one to find a positive relationship between Federal credit demands and interest rates. In 1976 and 1977 the Federal government's borrowing requirements were particularly heavy and yet other factors caused interest rates to fall on an annual average basis. Despite this potential problem, the empirical results demonstrate the strong tendency for excessive Federal credit demands to raise inflationary expectations and interest rates.

A further test of the disruptive effects of enlarged Federal credit demands is provided by examining their role in explaining actual inflation. If increases in Federal borrowing raise inflationary expectations, they should also affect observed inflation.

This hypothesis is also supported by the evidence. Over the 1958-80 period practically all of the variance in the annual inflation rate (as measured by the GNP deflator) can be explained by three factors: (Credit/GNP) ratio, the growth in M1B and changes in oil prices (% ch Oil P = % ch wholesale price index for crude petroleum).

$$\%\text{ ch P} = \underset{(0.32)}{-0.11} + \underset{(6.94)}{0.64}\left[\frac{\%\text{ ch M1B (T-1)} + \%\text{ ch M1B (T-2)}}{2}\right]$$

$$+\underset{(5.63)}{0.58}\text{ (Credit/GNP)} + \underset{(3.63)}{0.04}\ \%\text{ ch Oil P}$$

R-Bar Sq = 0.94 DW Stat = 2.06 Std Error = 0.67

All of the details in the story connecting Federal credit demands and inflation have not been fully worked out. For example, it is not easy to explain why the effects of credit on inflation operate more quickly than those of money. However, two supplementary tests indicate that the impact of Federal credit demands on inflation is unmistakable.

VI

One important criterion often used to judge the quality of an economic model is the stability of its parameters over time. As the following table shows, the money-credit-oil explanation of inflation easily passes this test. Column 1 shows the actual annual inflation rates from 1973-1980. The predictions of our model when it is fitted only through 1974 appear in column 2. The calculated values when the model is fitted through 1980 are presented in column 3. Columns 4 and 5 show the errors (actual minus predicted values) for the 1974 and 1980 equations, respectively. The errors from the equation that actually forecasts inflation after 1974 are extremely small and almost identical to the errors from an equation fitted through 1980. It is difficult to imagine a model of inflation that would generate more accurate and more stable predictions.

	Actual	Predicted Inflation		ERRORS	
	Inflation (1)	1958-74 Eqn (2)	1958-80 Eqn (3)	1958-74 Eqn (4)	1958-80 Eqn (5)
1973	5.70	5.97	6.01	-.27	-.32
1974	8.77	8.76	8.59	0.00	0.18
1975	9.20	7.85	8.12	1.35	1.07
1976	5.24	5.85	6.08	-.60	-.84
1977	5.83	5.91	6.08	-.07	-.25
1978	7.29	6.90	7.09	0.39	0.20
1979	8.51	8.07	8.18	0.44	0.34
1980	8.98	9.61	9.68	-.63	-.70

VII

Despite the stability of the model, it could be argued that the observed role of Federal credit absorption in the inflation process is a statistical artifact. The argument would be that the Federal credit variable is an endogenous variable and hence merely serves as a proxy for other variables. Use of an instrumental variables approach helps to answer this question. It involves regressing the (Credit/GNP) ratio on lagged values of inflation and on current and lagged values of other macroeconomic variables, such as money growth, the rate of change in real income, the level of interest rates and the unemployment rate.

The adjusted R^2 for this regression is 0.87, indicating that a substantial portion of the variance in the (Credit/GNP) ratio can be "explained" by other variables. However, the important question is whether the residual from this equation — the component of Federal credit that is not explained by other variables — is still a significant contributor to inflation?

The following regression addresses this issue; it is similar to the earlier inflation equation except that the (Credit/GNP) ratio is divided into two components: an induced or predictable component, which is attributable to other macroeconomic variables (Cred P), and an autonomous component, which reflects changes in Federal credit policy (Cred A).

$$\%\text{ ch P} = \underset{(0.13)}{-0.05} + \underset{(7.11)}{0.65}\left[\frac{\%\text{ch M1B (T-1)} + \%\text{ ch M1B (T-2)}}{2}\right]$$

$$+\underset{(3.16)}{0.94}\,(\text{Cred A}) + \underset{(4.83)}{0.53}\,(\text{Cred P}) + \underset{(3.91)}{0.04}\,\%\text{ch Oil P}$$

R-Bar Sq = 0.94   DW Stat = 1.98   Std. Error = 0.66

where:

Cred P = the predicted value from a regression explaining the (Cred/GNP) ratio

Cred A = (Cred/GNP) - (Cred P)

It is evident from these results that although the economy has a significant impact on Federal credit absorption, there is an independent, policy component and it is an important determinant of inflation.

Senator **Symms**. Mr. Chairman?

Chairman **Domenici**. Yes, Senator Symms.

Senator **Symms**. Mr. Chairman, I have a markup going on. I wondered if the Chair would allow me to ask one brief question that deals with this subject.

Chairman **Domenici**. Senator, I will do better than that. I will yield you my time and then I will pick it up at the end. You go ahead.

RETURN TO A GOLD STANDARD

Senator **Symms**. I thank you very much, Mr. Chairman; I appreciate your generosity.

This deals with what you have been talking about, Mr. Kudlow. I did really want to direct the question to Secretary Sprinkel because, as you know, Mr. Secretary, there has been a considerable discussion surrounding this issue of interest rates and anticipation in the future.

Many people are favoring the return to a gold standard. The proponents of this are maintaining that it would bring about less pressure for anticipation of a devalued dollar in the future, and people would lend them money for lower interest rates.

Now, along that line, I have introduced legislation which would provide a mechanism where we could get a dollar as good as gold, but this mechanism would allow gold to compete directly with the dollar system by having the Treasury mint U.S. gold stocks to make gold legal tender, thereby putting gold in direct competition with the dollar for every measurement of gold that is sold. The Treasury would be required, then, to cancel that amount of U.S. debt, and as a result there would not be any inflationary impact on the proposal and the gold would be an accurate standard of the dollar's value and it would put gold in competition with the activities of the Federal Reserve system.

Would you care to comment on this approach?

Dr. **Sprinkel**. Well, as you know, a Gold Commission is now operating. They have had two meetings; they will have a third shortly. Secretary Regan is chairman of that Commission. The Treasury is working very hard to assure that all important points of view on the issue of the proper role of gold in both the domestic and the international monetary system be explored carefully by the members of that Commission.

Until the commission issues its report, we are unwilling to take a stance on any particular proposal. Mr. Jordan is a member of that commission and he may want to respond to it.

Senator **Symms**. Would you want to make a comment on it personally, not as the administration's position?

Dr. **Sprinkel**. No, sir, I would not.

Senator **Symms**. Mr. Jordan, would you like to comment on that proposition?

PRICE STABILITY NEEDED

Dr. **Jordan**. I take the interest in the Gold Commission and the variety of proposals to be an indication of strong dissatisfaction on the part of the American people and the Congress with monetary affairs; that we are not willing to live with the continued erosion of the purchasing power of our Nation's money supply. We want price stability, and we are looking for some linkage to gold as one possible way to achieve that.

I think that if we can establish some rules for monetary behavior, whether or not they include a direct linkage to gold and whether or not there is coinage or convertibility to gold, the commission agrees that price stability is what we are going to try to do, and that any proposal that leads us in that direction is something we will consider seriously.

Senator SYMMS. Mr. Kudlow, would you want to comment on that?

RESTORE RELIABLE TREND OF FISCAL BALANCE TO BUDGET

Mr. KUDLOW. Well, I will echo what Jerry and Beryl have indicated, but I would add one point to it. In this inflationary context, we are all searching for ways to restore the value of money and stabilize prices. But I doubt seriously whether we can achieve those objectives of stabilizing money and price levels until we have restored a reliable trend of fiscal balance to our budget.

My reading of history, which is admittedly quite imperfect, tells me that down through the years, those nations who have used gold standards in some form or another have succeeded in stabilizing monetary value when they have been successful in holding down budget deficits not just for a year or two, but over the long run.

My general view on this is simply that fiscal credibility is the backbone of monetary credibility. No matter what the monetary approach is—whether it is a monetarist rule or some kind of gold convertibility, or the like—neither can succeed over any longer run period of time and neither can convince the public unless we have the strong fiscal backbone. And I think there is no quick fix except the tough work, as you know, of going into the budget.

Senator SYMMS. Well, then, would you agree with me that the only way to really achieve fiscal backbone is to address the problem of the transfer payment entitlements, and get on with it and quit wasting our time trying to think we can do this without getting into the transfer payment entitlement system and correcting those ills?

Mr. KUDLOW. I would, as a general matter, certainly agree with you, Senator.

Senator SYMMS. Mr. Chairman, I thank you very much, and I appreciate the committee's generosity to let me ask that question.

Chairman DOMENICI. I want you to know it was not the committee; it was the chairman. [Laughter.]

Senator SYMMS. I will remember that, Mr. Chairman. [Laughter.]

Chairman DOMENICI. Senator Chiles.

STILL LOOKING AT DEFICITS IN 1984

Senator CHILES. Thank you, Mr. Chairman.

I have listened to all these statements as to what we have done in the past, and I have looked at the charts that you put in your testimony to reflect that. But it seems like in the past what we were doing was continually spending more than we were taking in and building high deficits.

Each of your statements talks about the market looking at these deficits, and the reason we have not seen any break in interest rates is because the market is not convinced that we are really going to do something about the deficits.

Yet, when we look at the numbers that are projected by CBO, and even as the administration changes its numbers, we are still looking at tremendously high deficits in 1984.

Now, what is the difference between the goodies that we used to give out in the way of spending and the goodies that we are now giving out by way of tax cuts that are adding to that deficit?

We will have a deficit in 1984 that will keep us from balancing the budget, and is that not what the market is looking at? As long as the market is looking at that deficit, are we going to see any decline in interest rates, no matter what kinds of statements we make about monetary growth?

Mr. Kudlow?

HIGHER TAXES NOT THE RIGHT APPROACH

Mr. KUDLOW. Well, I certainly share your concern about deficits, and I think I agree with the thrust of what you are saying. But I will have to take one exception. On the matter of tax rate reduction, which the administration has, along with Congress, successfully pursued and implemented in 1981, I think it is crucial to recognize that the unsustainable rate of growth of Federal outlays, which seems to begin sometime in the midsixties and runs through to the present, has relied very heavily on the expectation that we can simply raise taxes and raise taxes, either directly or indirectly.

I think the economics effects of this tax increase process have become very clear. We have had, as you know, an average unemployment rate in recent years which is higher than anything over a 3- or 4-year period that we have experienced since the Second World War. We have had slower growth in real GNP. We have had slower growth in real capital, and we could both go down a laundry list of economic problems.

I do not believe that continuing on this path of higher taxes is the right approach.

TAX CUT DEFICIT OR SPENDING DEFICIT

Senator CHILES. Doctor, is a deficit any less a deficit if it comes from a tax cut rather than from spending?

Mr. KUDLOW. Well, I would have to say yes. I would have to say that——

Senator CHILES. Well, Mr. Stockman said the other day that writing a tax cut out of a deficit is not bad, so it is interesting that you all agree on that, it seems like.

Mr. KUDLOW. If I might——

Senator CHILES. Mr. Jordan, is a deficit any less a deficit if it comes from a tax cut rather than from spending?

Dr. JORDAN. Yes, sir, it is. The ultimate test of taxation is Government spending. When spending is being reduced as a share of national income, which is the objective of our program, then you are going to be reducing ultimate taxation.

As Mr. Sprinkel stated in his testimony, inflation also involves a very sinister, devisive form of taxation on money holders and on bondholders. It transfers real resources to the Government sector.

When you are cutting Government spending as a share of the national income, as is our objective, then you are leaving resources available to increased consumption and investment in the private sector. The 3-year tax program for individuals and the business tax cut put a ceiling on tax revenue as a share of national income, or they undo some of the recent ratchet or bracket creep that raised tax revenue that Congress never voted for.

Now, the objective is to bring spending down to the level of tax receipts. We no longer want a balanced budget at a larger share of GNP. A balanced budget at 25 percent of GNP is not preferred over a deficit at 20 percent of GNP. We want to reduce the size and the scope of Government.

Senator CHILES. Secretary Sprinkel, is a deficit any less a deficit if it comes from the tax cut rather than from spending?

Dr. SPRINKEL. Well, it makes a great deal of difference in terms of how the private sector reacts; that is, this deficit is coming about as a result of a cut in tax rates without, as yet, the needed slowdown in the rate of rise in Government spending. The reduction of marginal tax rates will provide greater incentives to save, greater incentives to invest, and greater incentives to work. Spending cuts will reduce Government as a percentage of the total economy.

Unfortunately, we have a deficit remaining. That means that we should continue to work toward getting that deficit down to zero. That will require continued restraint on Government spending.

Senator CHILES. But isn't the greatest shock and surprise to this administration that the private sector is reacting to the fact that a tax cut deficit is just as much a deficit as one on the spending side?

Dr. SPRINKEL. I do not think it is a shock and a surprise. We did not believe that we could come into this town and overnight——

Senator CHILES. You all said Wall Street is not reacting the way it ought to.

Dr. SPRINKEL. I have not stated that. I have spent most of my life in that business. I know full well that when you get a slowdown in economic activity and a change from massive money growth to low money growth, which is what we are now going through, it has adverse effects on financial markets in the short run.

The first give typically shows up in the bond market, and that is beginning to happen. The next give will show up in the stock market, and that has not happened yet.

TAX CUT POSSIBLY TOO LARGE TO MATCH SPENDING CUTS

Senator CHILES. Well, given the fact that tax cuts are better than stimulative spending, and Congress is ready to agree with that, is it possible we could have a tax cut that is too big which we cannot match with spending cuts? Could that cause the market to have an adverse reaction and could we continue to have high interest rates? Is that possible, or is any tax cut?

Mr. KUDLOW. I think it is important to note that not all taxes are the same, and I think one of the things the administration's policy has tried to establish is the difference between taxes on saving and investment on the one side and taxes on consumption and demand on the other.

It is crucially important, to reduce effective and marginal tax rates in order to lower the overall level of Government and restore incentives for savings and investment.

However, as you know, in the September budget request, the President has indicated a willingness to pursue the closing of certain tax loopholes and the elimination of tax abuses, not only to make the tax code more efficient, but also to strengthen our revenue situation. As you know, others in the administration have testified to this same effect, and we are exploring this now with Members of Congress.

I think that the issue of revenues deserves considerable attention in the period ahead in order to deal with the deficit situation. But I would also point out that raising revenues can get us back into the same old problem of the ever-growing size of Government, and this will hinder private sector expansion. So, we will have to pick our way very cautiously on this issue.

Senator CHILES. Then it might be possible that a tax cut could be too large?

Mr. KUDLOW. Well, it might be possible that the tax cut would be too large, but I would rather look at it more in the context of the structure and the nature of the tax cut. I would also point out that it may be wise in some cases to actually seek additional tax revenues to deal with the budget situation, as long as we do not interfere with the positive movement we have started in the direction of restoring incentives for investment and savings.

Senator CHILES. My time is up.

EFFECT OF RECESSION ON ECONOMIC GROWTH RATE

Senator KASTEN. Mr. Jordan, I guess it is official now; the President has said it and we have said it here today. The economy is in a recession; it might be called a slight recession. Could you give us your best estimate as to how long this recession will last and what effect it will have on economic growth for1982?

Specifically, will we still see the 3.4-percent growth rate in GNP for 1982 that we are basing our budget on?

Dr. JORDAN. OK. The 3.4 percent results from a pattern, beginning from the fourth quarter of 1981 going through the fourth quarter of 1982, of about 5 percent. We had that 5-percent growth target early in the year when the year-over-year was even higher. So, I prefer to look at it from the end of this year through the end of next year.

As I mentioned in my statement, the fourth quarter now looks like it is going to be flat, or it could even be a decline in real output, and whether or not the National Bureau ultimately declares this as an official recession, I really do not know.

We are currently still expecting that we will be gaining strength throughout 1982. We are in the process, as is always done at this time of year, of undergoing a thorough review of the economic assumptions, and those will not be complete until December, as we are finishing the budgetary process.

But we expect that the odds are greater that you will have a positive growth in the first quarter, gaining strength in the second quarter, and a very strong growth by the second half of 1982, when we get the second installment of the personal tax cuts.

Given the lagged effects of declining interest rates and the business tax affecting spending, and so on, we are looking at some surveys suggesting 16 percent nominal increases in capital spending, and 9 percent in real terms next year. We are expecting both the housing and the automobile industries to be improving, beginning with the first quarter.

We have been looking at the wide array of private forecasts, the majority of which still expect the first quarter of 1982 to show expansion in the economy, even though the majority now show, recently, a decline in the fourth quarter.

We do not have any new numbers for next year. The 3.4 percent on annual average will result from a projection from the fourth quarter of this year to the fourth quarter of next year.

Senator KASTEN. But you are telling us right now that you are going to stick with your numbers for the present time. Is that what you are telling us?

Dr. JORDAN. For the present time, there are no new numbers from the midyear. We are in the process of a ground-up review of those numbers; yes, sir.

Senator KASTEN. But after that ground-up review, it is more likely that the projections might be going down rather than up, is that not fair to say?

Dr. JORDAN. The fourth is going to be still fairly strong, but because of the way we are ending this year, compared to what we thought before—in our earlier numbers, we had a positive growth already in the fourth quarter this year starting up. So, with the year-over-year levels, it is not going to come to be that 3.4 percent. But that is arithmetic; that is not a forecast.

TAX CUT DELAY

Senator KASTEN. Mr. Kudlow, some of us in the Senate think that this recession we are talking about could have been avoided if we had stuck with the initial Reagan tax cut plan. When the administration first set out the economic program, it expected roughly two-thirds of the personal tax cuts to be effective by January 1982. As it turns out now, rates will only be cut 5 percent by then, and the little bit of tax relief we get by then is going to be wiped out by previously scheduled social security tax increases and also by bracket creep.

The only way that we can make things worse, I think, is by delaying the personal tax cut yet again, by either dropping it back 3 months, as is being talked about, or by stretching it out over a longer period of time.

Yet, some people are still pushing for a 3-month delay or for some kind of a change. Do you not agree that such a move—any kind of an effort to move the tax cut back—do you not think that that kind of a move would be disastrous?

Mr. KUDLOW. I always think it unwise to have Government constantly changing the rules of the game and constantly shifting about in its policies. I think in this particular context, the point you raise is very important because if we defer the tax cut or change the tax cut materially, then I fear that the investment community, the financial community, and the economy at large will simply not believe us.

Whatever revenue gains we think we may achieve if we defer or change the tax cut, it is likely that the economy will grow more slowly and the unemployment rate will be higher in the years ahead. Therefore, revenue gains that might be anticipated will disappear later on.

So, my feeling is it would be unwise to fiddle with the tax cut as it presently stands. But in my mind, that does not preclude the option of seeking revenue enhancement and receipt strengthening measures elsewhere.

I come back to an earlier question from Senator Chiles on this. All taxes are not the same, and I can distinguish—on reasonably safe economic grounds—between investment-oriented taxes and noninvestment-oriented taxes.

We have put in a good bill to create better investment and economic growth. If we want to deal with a shortfall in revenues and reassess our position there, I think there is ample opportunity in the tax code to find measures which would not impair the investment orientation we seek, but which would raise revenues and strengthen receipts in the outyears.

CONCRETE STEPS TOWARD BUDGET RESTRAINT

Senator **Kasten**. Well, Mr. Chairman, my time is up, but I would like to just conclude by noting that someone here said what we need are concrete steps toward budget restraint and that we need them now. I believe that within the next 2 weeks, we are going to see concrete steps toward budget restraint and that it is going to be not necessarily the President's program, but we are going to reach those goals of roughly $14 to $16 billion in 1982 and $100 to $115 billion over the long run.

We are going to try to reach those goals and, hopefully, we are going to demonstrate that we will take concrete steps. Now, the mix is not going to be the same as the mix that you proposed, and we would like a little leadership, frankly, from this side in terms of how to get that mix, especially as we start to work on the entitlements.

Chairman **Domenici**. From which side?

Senator **Kasten**. From this side over here—from Treasury and from OMB and from the administration. But we are going to do it on our own even without your leadership, and it is not going to be the mix that you gave us, but we are going to have entitlement reform, spending cuts, and tax increases. I guess we are going to call them—you had another term today; not revenue enhancement, but you said revenue nourishment?

Mr. **Kudlow**. Receipt strengthening, Senator. [Laughter.]

Senator **Kasten**. Well, we are going to have strengthening and we are going to have enhancements, and we are probably going to have increases by the time we are done. [Laughter.]

But we are also going to have changes in the entitlement programs. We are also going to have substantial cuts in the appropriated accounts, including defense. Hopefully, we are going to do that in the next 2 or 3 weeks, and we are going to start to see these interest rates come down, because if they do not, none of us are going to be in the positions we are in right this minute 2 or 3 years from now.

Mr. KUDLOW. I agree. I think, Mr. Chairman and members of the committee, that the revenue/outlay mix for this new package should be discussed at both ends of Pennsylvania Avenue. The administration encourages that kind of dialog.

Chairman DOMENICI. Thank you, Senator.

Senator JOHNSTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Are you for revenue strengthening?

MONEY SUPPLY GROWTH

Senator JOHNSTON. I am for all kinds of enhancements. [Laughter.]

Mr. Sprinkel, did I understand you to say that acceleration of growth in money supply, even by way of temporary deviation, is bad, and that the administration fully supports the policy of the Fed of what I would call tight money and what you would call a steady hand at the tiller?

Dr. SPRINKEL. Yes, sir. What we will need in order to achieve our objectives of getting inflation down, getting interest rates down, and encouraging capital investment is slow and stable growth in the money supply.

Senator JOHNSTON. All right, but what did Secretary Regan mean the other day when he said that the Fed was keeping the money supply too tight?

Dr. SPRINKEL. We have come through a period of slower growth than anticipated by the Federal Reserve. What we are arguing is that we want to have continued stable, moderate growth. We know that historically, there has been a great tendency for monetary growth to weaken as the economy weakens.

It is not accident, in my opinion, that if you look at past recessions and rank them by severity——

Senator JOHNSTON. I understand that. You will excuse me for interrupting, but let me just ask, did you want the Fed to temporarily deviate upward?

Dr. SPRINKEL. No, sir. What we want is stable, moderate growth in the money supply. What we do not want is a deceleration or even a contraction in the money supply, which has frequently occurred during a period of weakening economic activity.

Senator JOHNSTON. Well, what does that mean in terms of change?

Dr. SPRINKEL. In fact, if I could make the next point, please, the periods when we had the greatest decline in money were also the periods of greatest decline in economic activity. I think it is a causal relation. So, we do not want to make a weak economy weaker, nor do we want to have soaring money growth, which will get us back into the problems from which we are trying to extract ourselves.

Senator JOHNSTON. Well, what does Secretary Regan want the Fed to do with respect to——

Dr. SPRINKEL. I just stated what he wants—the same thing I want and the same thing everyone else in this administration wants, to the best of my knowledge; namely, stable, moderate growth in the money supply.

Senator JOHNSTON. Are they doing that?

Dr. SPRINKEL. On average, this year it has been quite good.

Senator JOHNSTON. You want the policy to continue, in effect?

Dr. SPRINKEL. Yes, sir.

Senator CHILES. Why did he criticize it?

Senator JOHNSTON. Yes. What was he criticizing?

Dr. SPRINKEL. You will have to ask Secretary Regan what he was criticizing. I can tell you what our objective is. Our objective is to get stable, moderate growth in the money supply.

Senator JOHNSTON. Let me tell you what some of the skeptics were saying. They were saying that Regan wanted to weigh in on the side of the consumer so he would be able to say, "Well, it is the Fed that is the problem," when, really, he was for the Fed policy. You are telling me he was for the Fed policy?

Dr. SPRINKEL. He is for stable, moderate growth in the money supply. [Laughter.]

CONVINCE WALL STREET OF MAJOR CHANGE IN ECONOMIC POLICIES

Senator JOHNSTON. All right. Now, Mr. Jordan, I understood you to say that interest rates of 25 to 30 percent would be the projection of where we have come in the past, taking the peaks and valleys of the past and extrapolating them up, and that is the reason that Wall Street fears those 25 to 30 percent interest rates, but that that will not happen now because you are going to change policies.

Dr. JORDAN. That is correct.

Senator JOHNSTON. But that is what is feared?

Dr. JORDAN. That is Wall Street's view of business as usual, and we have to convince them that it is not business as usual; there has been a major change in economic policies in this country.

SPENDING CUT PACKAGE

Senator JOHNSTON. All right. The administration has sent up a spending cut package, some $13 billion in scope, only $8.4 billion of which is outlays to the Appropriations Committee. I happen to be a member of the Appropriations Committee, and in order to make that very small, really, in total terms, $8.4 billion cut, we have got to cut 12 percent across the board in what they call the other budgets, other than defense and entitlements.

We do not seem to be able to do that; I say we cannot, but we are not in control. The committee chairmen do not seem to be able to do it, and that is only $8.4 billion. Yet, when you look at CBO's projections, without cuts or revenue enhancements or taxes, or whatever you want to call them, by 1984 we have a $178 billion deficit, according to CBO. And here we are, trying to cut $8.4 billion and have not been able to do so yet.

Now, is that the kind of reassurance that is going to tell Wall Street that everything is going to be all right; do not worry; we are chipping away at that $8.4 billion and we are going to try to figure it out? Is something going to happen so that we are going to be able to get the $8.4 billion and that is going to make this $178 billion problem go away?

WALL STREET CONCERN IS NOT SIMPLY DEFICITS

Dr. **Jordan**. On the budget, I will defer to Mr. Kudlow, but the Wall Street concern is not simply deficits, per se. They view that there are four basic options at this time, given the tax policy and that the revenue side of the budget is relatively fixed at this time.

If the economy is less robust—the projections of a lot of private forecasters are for a slower rate of growth than we have. If we are continuing to make progress on inflation and inflation is a lot less—this year already it is less than what we had earlier said it was going to be; indications are that it may be less in 1982 than we said. Less inflation means less tax revenue.

Declining oil prices or flat nominal prices and declining real oil prices mean less tax revenue. The people in the private markets know this. It is not deficits by themselves, with nothing else, that concerns them.

We could live with larger deficits, even with Government spending being reduced as a share of national income, so you have larger consumption and investment as a share of national income. But they are looking for a mix, at least, of more investment spending and less consumer spending. They are not sure that that is going to result from the program.

You can reduce Government spending further in order to narrow the deficit and bring it down to the level of revenue, or you can opt for monetary stimulus.

IS THERE A CURE FOR $178 BILLION DEFICIT

Senator **Johnston**. What I am getting at is do you believe for 1 second that you are going to cure a $178 billion deficit at the rate we are going?

Dr. **Jordan**. Well, I do not——.

Senator **Johnston**. Does anybody believe that. Let me tell you, at least Main Street in my State is saying: "Give them a chance. They won the election; give them a chance. We do not like what has happened in the past." But Wall Street is saying they do not believe for a New York second, and Washington is saying—well, I do not believe that if you even questioned the chairman—I will not ask the chairman. But if you questioned Members of Congress, they do not believe it.

You know, for a while, it was a question of somewhere along the way, there was going to be this Kemp-Roth dividend; this Laffer curve was going to come down and solve our problems, but you just sort of had to believe. But nobody believes anymore; the credibility of this program is down around zero.

I voted for it; I am looking for a reason to believe. Can somebody make me believe anymore?

Mr. **Kudlow**. Well, it is hard to make you believe, Senator, but some of the numbers are a little high. I do not know about the $178 billion. Is that the level of the deficit in 1984?

Senator **Johnston**. No.

Mr. **Kudlow**. That is cumulative, I believe.

Senator JOHNSTON. With no cuts and with no revenue enhancement, it is $178 billion.

Mr. KUDLOW. Well, we, as you know, have some disagreements with the CBO numbers. But, more importantly, in a policy sense the President's September budget request, which calls for a $16 billion improvement in the expected deficit for fiscal 1982, would, if carried through successfully to 1984, aggregate to an $80 billion improvement, which leaves us, by our own reckoning, some $35 to $40 billion short, from the data presented in support of the President's objective of a balanced budget by 1984.

BUDGET HAS $343 BILLION LEFT FOR POSSIBLE POLICY ACTIONS

Senator JOHNSTON. The problem is that you have said you are not going to deal with entitlements, or at least not with social security; you are not going to deal with defense. If you take defense, social security, and interest on the debt and that is, what, two-thirds of the budget?

Mr. KUDLOW. Well, by our estimates, even if we exclude defense and if we exclude social security and if we exclude net interest costs, we are still left with a considerable portion of the budget to contend with insofar as future actions toward restraint, by our estimates.

Senator JOHNSTON. Medicare, medicaid, the FBI, the CIA.

Mr. KUDLOW. Well, we have had these discussions with this committee and with other committees, and by our reckoning there is some $343 billion left in the budget to contend with for possible policy actions, even when we eliminate defense, the interest, and the social security.

Now, I think the $340 billion, even if we concede a margin of error on both sides, presents plenty of room to maneuver. And in that context, the President's request of a 12-percent across-the-board reduction, which would come to about $8.5 billion, is not an exorbitant number.

Senator JOHNSTON. No, it is not.

Mr. KUDLOW. My feeling is that what is necessary in terms of persuading markets—and I agree with you that the skepticism is quite high, and I have indicated as much in my testimony—the fact remains that we are never going to start making a dent and improving those public attitudes unless we take further, additional, concrete budget actions.

The numbers are there, Senator. What I think the public is concerned about is whether the administration and the Congress and Washington, in general, has the will to go after those numbers. But the numbers are there; there is no doubt in my mind.

Senator JOHNSTON. You mean the big deficit numbers?

Mr. KUDLOW. No. I mean the possibility for additional budget restraint; those numbers are there, and I think we have to contend with them in a serious, straightforward fashion. Let me repeat that the President's September budget request, by itself, will dent these expected budget deficits by $80-some-odd billion, and that is before we get into the 1983 fall review process.

So, I think that if we can take some concrete steps in the near future and if what Senator Kasten indicated earlier is indeed true and some kind of consensus perhaps is emerging, then I think we can begin to persuade the public not only that Washington is serious about dealing with the problem of fiscal discipline, but that we are all willing to follow through from the actions taken this past spring and summer.

I do not see any way around the issue of following through not once or twice, frankly, but it has taken us 15 or 20 years to put ourselves into this structural situation. It is going to take us several years of repeated action and repeated followthrough to get us out. You cannot turn a business around in just a few months; I am sure you understand that, and I think the public understands it as well.

Senator JOHNSTON. My time is up. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator.

Senator Gorton?

TAX OPTIONS

Senator GORTON. Mr. Kudlow, I would like to ask you to follow up on some of the statements you made about revenues to Senator Kasten earlier, and perhaps to describe to me a little more specifically what kind of taxes or revenue about which you are speaking you think it would be foolish to back away on as far as the last tax package is concerned, and what types you think are appropriate in helping to balance a budget, and then perhaps describe the economic impact of the latter.

INVESTMENT AND PERSONAL RATE REDUCTIONS

Mr. KUDLOW. Well, the first point is I think we should stay away from any changes in the investment and in the personal tax rate reductions we have already achieved.

Senator GORTON. All right. Now, does that include the sale of tax losses?

Mr. KUDLOW. Well, I am not a tax expert, but my sense is, looking at the whole situation, that we have achieved a package which reduces marginal and effective marginal tax rates on business income, and we should keep it intact. The minute we go back into that bill and start reopening it issue by issue, I think you are going to create a major turn of sentiment in the business community away from investment in business structures and the like.

I think that it would be a great mistake and that the public's confidence would drop sharply. I would not tamper with that bill; I think it was a major achievement by Congress and the administration to get that into law.

However, as others in the administration have already indicated, I would be happy to look into a variety of areas in the tax code where abuses have crept in in recent years where certain inequities exist, and where business has continued to receive what amounts to a subsidy from the Government through the tax expenditure route.

Business does not need that tax privilege anymore because we have changed the corporate tax rate and depreciation structures so much that we can now look into the issue of loopholes and the like as a means of correcting abuses and strengthening receipts.

I also feel, consistent with our view to improve the saving and investment incentives throughout the economy, that we should not be bashful in looking into areas where the tax code is geared precisely to aid consumption rather than investment. This, it seems to me, might include a——

MORTGAGE INTEREST DEDUCTIONS

Senator GORTON. Mortgage interest deductions?

Mr. KUDLOW. That would be an option that might be considered. The Congressional Budget Office has just published an interesting and careful study and I think that is something that ought to be discussed. I think we should look at a variety of excise taxes.

At this point in time, if you and I can agree that we must take some concrete actions as soon as possible to deal with the deficit situation and the resulting public skepticism and if we can leave the investment side alone and go to the consumption side, then we should have a full and open discussion of the whole range of tax options. This is exactly the time to do it, and indeed, the public wants us to do it.

VALUE ADDED TAX

Senator GORTON. Where does the value-added tax fall into that statement of philosophy?

Mr. KUDLOW. One should not preclude looking at and evaluating, for better or worse, any of the various tax arrangements which have been discussed from time to time. I think this is exactly the right moment to do it.

I do not wish to endorse or support a value-added tax. My chief point this morning is to suggest that all tax revenue enhancement, receipt strengthening, and loophole issues are good grist for the mill. Since we recognize the urgency of the situation, then let us go forward and examine the options very carefully.

Senator GORTON. Are the various provisions of the tax bill which we passed at the end of July relating to oil loopholes or investment incentives an option to be discussed?

Mr. KUDLOW. Well, I share what I think is a certain implied skepticism as you ask that question. But, again, I fall back on my earlier position. I think it would be unwise to reopen that legislation. It was very difficult to put together. The bill, in each of its many diverse parts, is not a perfect bill; no bill ever is. And I am learning that that is particularly the case with respect to tax legislation.

But on balance it remains a good bill and it achieves what we all desired: to improve the saving, investment, and economic incentives needed to get us back toward recovery as soon as possible. I think that to look into that bill would create an unraveling process which would do grave damage to Government credibility, which in turn would do grave damage to the economic recovery we all want. I think we should look elsewhere. There is certainly no shortage of options away from that bill.

Senator GORTON. Thank you, Mr. Chairman.

DEFICIT RESTRAINT

Chairman DOMENICI. Thank you, Senator.

Let me ask all three of you—perhaps it is more related to Dr. Jordan and Dr. Sprinkel, but I have been doing the best I can to study what you all have basically summarized this morning—you know, that failure on the part of interest to follow the trend line of inflation. I looked back and found that it did for a number of years; in fact, in part of a year, interest was lower than the CPI, and that is in recent history.

I understand very clearly your position, and as I understand it, it is that principally there is skepticism as to whether or not inflation will really remain down and consistently remain down, and therefore the apparent willingness to risk, which obviously was done in previous times, is not there. I understand that.

I also understand that you are all suggesting a very traditional solution to this problem—a moderate money supply and further commitments to the reduction in deficits. I hope you all understand that that is what the President is telling us and that is what many of us are disposed to do.

We have summarized the President's deficit restraint package, and it adds up to $115 billion; you have used $80 billion because you did not use the unidentified portion. Now, you all have been in for a while; it is not 60 days after election to get a package through. I hope you understand that if we move in that direction and do it quickly—and there may be a process whereby we can make that kind of commitment here in the Congress—it has got to solve the problem. I mean, we cannot come back here in 8, 9, or 10 months, if that is done, and have another historical résumé of what happened in the past. It has got to work.

Now, I am very committed to the fact that it has a high probability of working, but I wonder if you have looked at the whole change in the national scene that has occurred in the last 12 to 14 months and if there are any other things that have been happening in the money markets that concern you to indicate that maybe the traditional approach that we are talking about here just might not work.

BANKS HAVE MONEY THAT THEY ARE NOT LENDING

For instance, if I am wrong on this, correct me in your answer, but I am led to believe that the typical bank in the United States has a lot of money around to lend; they are not lending it. I checked when my bankers came here and I was absolutely amazed. I went around the table, and every one of them were underloaned by huge percentages. I conclude that that is a rather general situation in the country.

They have money that they are not lending, and yet we are saying it is the supply/demand situation that is causing these high interest rates. Now, that puzzles me. If supply/demand is exerting that much pressure, why are my banks only 40 or 50 percent loaned? Where is the demand? It seems there is a supply there. That is the first point.

HUGE AMOUNTS OF MONEY RESOURCES ALLOCATED TO ENERGY FIELD

Second, we are told that by deregulating and making a national commitment to energy independence, we have allocated huge amounts of our money resources to the energy field, and I am not objecting; I endorse it. But is it not a distortion that we ought to consider in terms of where the money is going to go?

The oil companies have no difficulty getting a $10 billion line of credit and paying 21 percent for it. Penzoil did that just at the threat of a merger. That seems to me to be something that I do not have an answer to, but it certainly seems to be a demand distortion that is significant.

BANKING INDUSTRY DEREGULATED

Third, we have deregulated dramatically the banking industry—some under pressure, some by design. I just heard your boss, Dr. Sprinkel, say that 3 or 4 weeks ago, you were for taking that 5.5 percent off on the regular accounts. Then he said, "No, let us leave it on. The money situation is in a state of confusion, so let us leave it on. At least it has a little bit of a downward leverage."

Now, are there any major situations in this money supply economy that are different from 3 or 4 years ago that should cause us some concern as to whether or not a next round of deficit restraints—a $115 billion down payment on whatever the 3-year deficit is—might not work? Would you all answer that?

HISTORY STRONGLY SUGGESTS THAT RESTRAINT WILL WORK

Dr. **Sprinkel**. I am very confident that it will work. We have a lot of history not only in the United States but in other nations that have moved from massive stimulus, both on the fiscal and monetary side, to restraint. There is not one up to now that has not been accompanied by declining inflation rates and declining interest rates.

We have tested the reverse in recent years with massive monetary and fiscal stimulus, and we know what the results were and we do not like them. So, history strongly suggests that it will work.

Now, on the question of banks being less than fully loaned, we must distinguish, I think, between money on the one hand and credit on the other; that is, we are arguing and supporting the Federal Reserve in its desire to slow money growth. Some would call that tight money; I call it something different, because if you get slow growth in money, inevitably you will get easy credit; that is, those rates will come down.

There is pressure presently on the prime. The spread between the prime and the CD rate has widened somewhat, indicating that the prime is likely to move on down. So, I just have no doubt whatsoever that the program will succeed, if followed through.

On the deregulation side, our interest—and I think the interest of many in the Congress—is to create a level playing field between the various institutions—investment banks, savings and loans, mutual savings banks, and insurance companies.

Chairman **Domenici**. Right.

Dr. **Sprinkel**. We still have a large number of regulations that were initiated in the Great Depression and have continued, even though we have had massive changes in markets. And it will be the effort of the Treasury, as the Secretary argued earlier this week, to move aggressively over the next few months and years to deregulate those institutions. There is nothing inconsistent in that move and the fact that we are going to get interest rates down.

ALLOCATION OF CREDIT

Now, on the other question as to allocation of credit, I personally think that the allocation of credit is much better left to the marketplace, provided we have the competition out there, than either the Administration or the Congress trying to direct the allocation of credit. The evidence in the past suggests that the marketplace works very well on that score, and that is certainly what we would urge be the guidelines for the future.

MARKET-ORIENTED DISTORTIONS IN CREDIT DEMAND ARENA

Chairman **Domenici**. I did not suggest anything to the contrary. I merely am, just as a layperson, looking out there and it appears to me that there are some very significant market-oriented distortions in the credit demand arena that were not there 2½ years ago.

I mean, I can recall when we were in the middle of the battle on energy independence and we had everything regulated. I think you remember, Dr. Jordan, that the energy companies were coming forward with numbers of how many billions of dollars it would take to make us energy-independent.

I remember the president of Arco, a distinguished resident of New Mexico, at one point 6 or 7 years ago saying it would cost us $350 billion in investment to become energy-independent. And it just appears to me that we have moved rather rapidly in permitting that claim on available credit to become a reality, and it is a very big claim on the credit and it is a very profitable industry and will continue, and therefore it is not as inhibited as a car dealer.

Pennzoil went in for $10 billion at a 21-percent line of credit to avoid a merger or takeover. That is pretty easy for them; it is not very easy for anybody else. It appears to me that those kinds of things have happened.

I know the military-industrial complex was weak and I know it is still weak; it has got to get stronger. But it is not going to work at a nonprofit; you can rest assured of that. The way we are doing it, they are assured of a profit. That is and will continue to become a very huge demand on the credit market, will it not?

If they are going to build what we expect them to build to help us refurbish, that is a very, in a sense, distorted demand, is it not? It was not there 4 or 5 years ago. Are any of those worth worrying about, or is it full speed ahead, with $115 billion in fiscal restraint and revenue enhancement, or whatever you call the new name, so that we reduce the cumulative deficit?

I mean, is that it—full speed ahead there, and that is all we have to do?

BANKERS HOLDING TOO MANY GOVERNMENT SECURITIES

Dr. **Jordan**. Let me comment first on the bankers' remarks about not being fully loaned out. Of course, their balance sheets are balanced and they are holding earning assets, but they are saying they are holding a lot more Government securities, Government-guaranteed securities, and maybe loans to other banks than they would like to be.

As Mr. Kudlow mentioned in his testimony, with on-budget, off-budget, and Federal guarantees approaching absorbing 50 percent of the funds raised in the financial markets, obviously if the Government sells securities or guarantees securities that are sold, somebody is going to wind up owning them. And much too much of our national saving has been going through this channel.

The bankers are saying that they would rather be making loans to big business, small business, car dealers, home mortgages, and builders, but they are winding up holding more Government securities, Government-guaranteed bonds, or other things simply because, given the risk/reward kind of relationship, that is the best deal that they are getting.

The supply has been enormous; it keeps coming in. The Treasury keeps coming into the market in these enormous amounts. They really have no choice but to wind up owning it. The public has to wind up, either through the banks or directly, owning all the securities that the Government sells.

We want to reduce this presence of the Government in every way in the credit markets in order to leave more room for the financial system to provide the credit to what we consider to be much more productive sectors in the economy, to bring about a resource shift away from consumption-oriented activities and toward more productive activities—activities that will create jobs and raise standards of living.

If you go back and review the history of the 1970s, the first oil shock in 1974—we recognized that it did make us poorer and it made the OPEC nations richer. But we behaved as though it did not make us poorer; we tried to avoid the effects of that.

It had a very damaging effect to our basic industries—the most productive, highly energy-intensive industries. In 1975 and 1976, we had declining inflation and declining interest rates even though we had very large deficits, and we had an expanding economy. Rate declines continued into early 1977.

But then, in 1977 through 1979, we had massive amounts of monetary and fiscal stimulus to the economy that severely damaged inflation psychology. An ordinary individual did two things. They first bought a book on how to beat inflation, and then they borrowed as much money as they could and bought real estate, and this drove the savings rate down dramatically—people's willingness to go into debt to avoid inflation.

Chairman DOMENICI. Yes.

GET INDIVIDUALS TO DEFER CURRENT CONSUMPTION

Dr. JORDAN. We have got to reverse that. We have got to get the individual to be willing to forego or defer current consumption, on the promise that he is going to get a fair aftertax, afterinflation real rate of return, so that he is willing to hold more forms of savings other than simply the equity in his home.

All parts of our program go in that direction, and we have run into places where we cannot pick and choose among the parts of the program. We are convinced it will work if all four pieces are enacted together. We are concerned about any tendency to pick and choose and sacrifice one part of the program, and the whole thing will unravel.

TIME TO BE REALISTIC AND HONEST ABOUT CUMULATIVE DEFICIT

Chairman DOMENICI. All right. Let me just try one more on you. While the $178 billion that Senator Johnston is talking about of cumulative deficit may be questionable, I think it is time to be realistic and honest.

The deficits are tremendous in the outyears, and, if anything, the estimates that OMB has made for the 1982 deficit are too low. I think you acknowledge that. With the recession, that $59 billion that they estimate is too low. I am just going to give you some kind of middle-of-the-field numbers, and just add up the three.

Let us say, for purposes of being modest, that it is $65 billion for 1982. For 1983, you are talking about $63 billion; I think to be honest, you ought to be talking about $75 billion. For 1984, you are talking about $59 billion; I think, to be honest, you ought to be talking about $70 billion.

Now, every one of you has contended that moderate money policies and moving in the direction of taking a big bite out of that cumulative deficit are the missing ingredients for market confidence. Is that a fair assessment?

Dr. SPRINKEL. Yes, sir.

BUDGET RESTRAINT OR REVENUE ENHANCEMENT

Chairman DOMENICI. Now, if we are going to get $115 billion as an 1982 commitment on that cumulative deficit, you cannot get the entire appropriation that the President wants. Well, let us just say, between defense and discretionary appropriations, you can get $25 billion for the 3 years; $25 billion from $115 billion leaves $90 billion.

We cannot touch social security. In all negotiations with the White House, a firm commitment by the President says that is for the Solvency Reform Commission. You cannot honestly expect to get all of that $90 billion out of entitlements; that is all that is left. You can get a good down payment.

We have got to be thinking about revenue enhancement, revenue raisers, or whatever the new phrase is, of a very high number. Now, I am going to go with the assumption that we should not touch the 1982 tax cuts. Because of the mild recession, it would probably be foolhardy in any respect.

But would you not agree that we have to be looking at a significant package of revenue raisers over the 3 years, and anything like $18 to $20 billion is not really going to do the job?

Now, if you do not agree with that, then you tell me—and if you all want to look over at OMB, look over at them—you tell me how we are going to get it.

Dr. JORDAN. What you are suggesting, Senator, does involve some differences in economic assumptions from what the administration had at midyear, and we are working very hard on that, including looking at the wide range of assumptions of all kinds of forecasters.

Suppose inflation comes down much more rapidly than what we had earlier expected; suppose real growth is less rapid. What does that do to revenue? What does it do to revenue as a share of national income, and what is the range of the problem? As you suggest, it can be quite large.

Unfortunately, when inflation comes down, the major benefit we get is that interest rate expense on the national debt declines more than we had assumed, and that is desirable. That is somewhat of a mitigating factor. But the much larger effect is that we simply generate less tax revenue through our system, especially with the tax legislation already in place.

So, the kinds of numbers you are suggesting, I think, are in the ball park of what the job is to be done.

Chairman DOMENICI. Well, doctor, I am not trying to argue what the numbers are. Let us use your numbers. I am asking you whether we can find, in the next installment on the cumulative deficit—use your numbers, use CBO's numbers, use the consensus economists' numbers, whichever you want—I am asking you if any of you think it is realistic to find $115 billion, given that we are not going to get the appropriations savings.

We will get a significant amount; I just threw out a ball park number for the 3 years of $25 billion. Do any of you really think we can get the $90 billion with pure restraint in budget, or must not a significant portion of it be tax enhancement?

Dr. JORDAN. I believe some has to come from both sides; yes, sir, I do.

$21 BILLION TAX ENHANCEMENT

Chairman DOMENICI. How about you, Mr. Kudlow? Why do you not start with a frame of reference of the President's $21 billion in tax enhancement? Is that realistic in terms of this mix?

Mr. KUDLOW. I think it represents a start, Senator, but I agree with your diagnosis of the situation in broad terms. I think that your numbers are reasonable; I do not know as we would disagree with them in any substantive way.

I think the administration has already signaled Congress of its willingness to engage in a discussion on the receipt strengthening measures. I am not sure I can accept entirely the view that the best we can do on the spending side is $25 billion over 3 years. My sense is that that number may be a bit low, but I certainly——

Chairman DOMENICI. That is on discretionary appropriations, including defense.

Mr. KUDLOW. Well, my sense still is that that number may be a bit low, but I will not quibble with you because I strongly endorse your diagnosis and your prescription in general terms.

We are all coming to the recognition that the deficit is not going to magically evaporate and that the economy is not likely to improve in any sustained, significant way until we restore fiscal credibility and get interest rates down. Having come to that recognition—and it has not been the easiest recognition to come to—it behooves us now to get moving on the revenue options.

But I make one request. In all seriousness, I think it would be a grave mistake to unravel the tax bill which has already been implemented. I think there is sufficient grist for the tax mill elsewhere which we can defend analytically and on budget grounds to achieve the revenue-raising numbers that you have hinted at. I think that is the way we should go and, as you know, I think that is the way the Administration is headed.

CHANGE PERSONAL TAX CUT

Chairman **DOMENICI**. Now, just for purposes of talking about which is better, I have already stated my position that the 1982 tax package—that is, going from 5 to 15 percent on individuals—in my own personal opinion, we should not tinker with that, for certain.

Is it better for the economy that we look at the next one when it goes from 15 to 25 percent, if there is any deferral being considered of 3 or 4 months, or 6 months? Is that less detrimental to recovery and the other thrusts than the first one?

Mr. **KUDLOW**. It may be, but there is an enormous risk here. If I may for a minute explain that risk, it is not so much in precise terms that we know what elements of the economy will respond exactly to which parts of the tax cut in which year.

Chairman **DOMENICI**. Right.

Mr. **KUDLOW**. Frankly, we just do not possess that knowledge. But my great concern and the reason I worry about the risk is the very important issue of constantly changing the rules of the game.

Chairman **DOMENICI**. I do not expect you to answer the question from the standpoint of what you advocate. I advocate neither the 1982 nor the 1983 on the individual; it is not up to me. If anything, it is up to this committee to come up with a package target for revenue, allocating it between the 3 years.

I am merely asking if it is better to look at 1984 rather than 1983, when you are talking about any kind of change in the personal tax cut. I understand that your position is that you ought to look at neither; that you ought to look at everything else first. Is that correct?

Mr. **KUDLOW**. That would be my view.

Chairman **DOMENICI**. All right.

Mr. **KUDLOW**. Senator, that would be my view.

Chairman **DOMENICI**. Dr. Sprinkel?

Dr. **SPRINKEL**. Yes, sir; I agree with that. What we want to do, as you have indicated, is to get the deficit down absolutely and as a percentage of the total GNP. Perfection would be zero deficit, obviously. We are unlikely to be able to achieve all of these objectives but it is critically important that we continue to restrain the rate of rise in Government spending so that we can reallocate resources in a way that does not adversely affect the incentives that were instilled by this latest tax bill.

Chairman **DOMENICI**. OK, thank you very much. Senator Armstrong wanted you to supply the following information. When will we get the details on the President's credit reduction demands in 1982?

Mr. **KUDLOW**. The administration's package, Senator, is virtually complete, and I would say, today being Tuesday, that there is an excellent chance before the week is out that that package can be finally sent up to the Congress and can be made public.

As a fallback position, if we are unable to meet the end-of-week deadline, I would feel very confident that by the earliest part of next week, the package will be sent forward.

IMPACT OF CUMULATIVE DEFICIT RESTRAINT ON MONEY MARKETS

Chairman **DOMENICI**. Would you supply the following for me for the record? You have all made the point that there is Government intrusion in the money markets to an inordinate degree. You have gone into some detail, Mr. Kudlow, on the historic growth in that; we have all agreed that that is an important part of the problem.

Would you take for me the President's proposal on off-budget restraint, assume it is a given, and then assume we have reduced the cumulative deficits by $115 billion, and give this committee information as to what kind of impact that really will have on the money markets? [1]

I mean, we are talking about such an enormous debt that we are servicing that turns over; we would like to know that it is real and it is not one of these that we expect people to rely upon.

But your 20 percent off-budget reduction, carried out over the 3 years—if you will conspire and all three of you take that as a given, and then give this committee some objective indication of what $115 billion in restraint will do to the Federal Government's intrusion into the money markets in some way that we would understand—5 percent less, 8 percent less, or whatever it is.

Now, my last question: all of this that you are talking about assumes that our goal is to keep inflation down and to convince those who have been burned historically in the money markets—by it not staying down and they get promised that, I assume that you are also telling the President and telling us that this kind of action will get it down and keep it down. Is that correct?

Dr. **JORDAN**. Yes, sir.

Chairman **DOMENICI**. And that is purely the restraint on the cumulative deficit contemplated that will do that?

Dr. **SPRINKEL**. And monetary restraint.

Chairman **DOMENICI**. And monetary restraint. All right, thank you very much.

It is your turn. Did you want to ask some questions, Senator Chiles?

Senator **CHILES**. Oh, no, I just really stayed so I could hear yours.

Chairman **DOMENICI**. Thank you. I waited until last because I thought you would be interested. Did you have any questions?

Senator **CHILES**. Yes; I did have a couple of others.

Chairman **DOMENICI**. Please.

EASING OF THE FEDERAL RESERVE

Senator **CHILES**. Mr. Sprinkel, we have had a lot of discussion on the Secretary's comments in regard to the Federal Reserve.

[Whereupon, Senator Gorton assumed the chair.]

Senator **CHILES**. Do you think the Federal Reserve has, in fact, eased up in the last few weeks?

Dr. **SPRINKEL**. Interest rates have come down in the last few weeks. Up to now, there has not been any sharp acceleration in the monetary aggregates, with the exception of last week when we had a very sharp rise in M_{1B}, brought about almost certainly by very temporary, technical factors.

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[1] Not received at time of printing.

So, I see no evidence that there has been a significant easing on the part of the Federal Reserve. I think they are trying to stay in their given path of providing stable growth in the money supply.

Senator CHILES. Dr. Jordan?

Dr. JORDAN. It would be a mistake to interpret declining interest rates, as they continue this year or next year, as a lessening of the resolve to fight inflation. I think Fed policies are on course. We will have, probably, more rapid money growth in the months ahead than we had in the third quarter by itself.

It is not an easier policy; it is not more stimulative; it is not more inflationary. It is in a course that will lead to less inflation and lower interest rates.

Senator CHILES. Well, I am not talking about their policy or what we should think or anything else. I am just asking you, do you think they have eased up?

Dr. SPRINKEL. No.

Dr. JORDAN. They have allowed interest rates to be pulled down by market forces.

Senator CHILES. That is all I have.

Senator GORTON. Thank you very much.

[Whereupon, at 12:13 p.m., the committee was adjourned.]

VIEWS OF THE REAGAN ADMINISTRATION

FRIDAY, OCTOBER 30, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 11:15 a.m., in room 6202, Dirksen Senate Office Building, the Honorable Pete V. Domenici, chairman of the committee, presiding.

Present: Senators Domenici, Armstrong, Boschwitz, Symms, Grassley, Quayle, Chiles, Biden, Sasser, Hart, Metzenbaum, and Riegle.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; William Stringer, senior economist and assistant to the staff director; and Lizabeth Tankersley, minority staff director.

Chairman DOMENICI. Can we have order please?

Did you have a logistics complaint, Senator Metzenbaum?

Senator METZENBAUM. None that I care to voice publicly, but I'm getting tired of seeing the back of my head on the TV cameras. [Laughter.]

Chairman DOMENICI. I knew that was his complaint, and I told him that he was just suffering from what we suffered for many, many years, the back-of-the-head treatment.

Senator METZENBAUM. It is better than the back of the hand.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. Mr. Secretary, we welcome you to this committee. As you are aware, it is our present plan to start marking up the second budget resolution next week. For this reason, we are anxious to receive your views on tax policy, the effect of budget deficits on the financial markets, and the outlook for interest rates and the overall economic outlook.

We clearly face a very difficult situation. Interest rates are very high, although they have moderated somewhat, and the economy appears to be weak at this point. The Congress took several positive steps to address this problem last summer in enacting the omnibus reconciliation bill, which reduced spending rather dramatically; and it passed the Economic Recovery Tax Act, which you were instrumental in helping the President pass, which, as you know, substantially reduced taxes.

But I think we could all agree that there is clearly more to do. We knew that last year when the President asked for additional budget cuts in 1983 and 1984 of a substantial nature. In fact, those amounted to somewhere around $70 billion in the budget documents that were sent up. We knew last spring when we developed the first resolution that that was the case. From my standpoint I am not surprised about that. But it does appear that perhaps that is not enough when we look at the economic situation at this point.

I hope you will provide us with some guidance, Mr. Secretary, on how to approach this very difficult task as we attempt to bring spending more in line with taxes. In addition I hope you can discuss today, if you have access at this time, to any internal forecast that you might have with reference to the economy for the next 3 years.

I want to say that I greatly appreciate your accommodating us today. We have been, at the request of the minority, attempting to complete whatever witnesses we are going to hear from before the markup. It is obvious that they wanted you to appear, and I think they are correct; before we markup, we should hear from you. It has been difficult to work that around your schedule with the international meetings you have attended and the other things, but I am delighted that we were able to accommodate both you and the committee today.

With your permission, we will try to remain through the lunch hour if that is all right with you since we started late and at least look at 1 o'clock or thereafter as the time that we would finish.

With that, Mr. Secretary, do you have any opening remarks? Would you like to open?

Do you have any opening remarks, Senator? Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator Chiles. Thank you, Mr. Chairman. I am pleased that you have arranged for the Secretary of the Treasury to be here today. After listening to the administration's economists last week, I think we really have to hear from the man at the top on some of these issues.

The first area that I hope the Secretary will address is our monetary policy. It seems to me that on Mondays, Wednesdays, and Fridays I see an article where the Secretary wants the Federal Reserve Board to ease up. And then on Tuesdays, Thursdays, and Saturdays the White House issues a clarification saying that the administration still wants a tight monetary policy. And then on Sunday we all go to church and pray for lower interest rates.

I hope, Mr. Secretary, you will tell us specifically whether you think the Federal Reserve has been too tight in the last month, if they have been too tight over the last 6 months, and looking not at their targets but at their posture, and at their day-to-day intervention in the credit markets, do you think that they have been putting enough reserves in or draining too much out?

The second area that I would like to have the Secretary address is how long we can keep living with these high-interest rates. The impression that a lot of people have is that the administration does not care whether high-interest rates have caused the largest decline in housing since the Great Depression, does not care whether automobile dealers are going out of business, and does not care whether farmers are getting squeezed as they try to finance their land and equipment. We hear that, in the long run, interest rates will come down. Yet, many of us do not think the economy can afford to lose these sectors while we are waiting for a year for interest rates to decline.

I also would like to have you tell us, Mr. Secretary, why you think it is best at this time to take a $21 billion cut in the Federal credit programs for just those sectors that right now are being hurt the worst: Housing, small business, and agriculture.

Finally, Mr. Secretary, I would like you to tell us what plans you have to help the thrift institutions survive through the credit crunch. What I hear seems to be that you want to make it easier for the local thrift institutions to be merged into the larger banks. I wonder whether you care that there is someone in a local community who is dedicated to making loans for home mortgages and small businesses, or is this just a part of the bigger is better philosophy, which would reduce antitrust enforcement? Right now it seems to me that only big business gets the kind of credit that they need for mergers and acquisition that they are interested in right now.

Mr. Chairman, I look forward to the hearings. I certainly welcome the Secretary to the committee.

Chairman Domenici. Thank you, Senator Chiles.

In the past what we have tried to do is to have the chairman and ranking minority member make brief opening remarks and then go to the witness, but I will alter that. Senator Metzenbaum wants to make a few remarks. Senator, I would really appreciate it if you would make them brief. We will try to get back to you in very short order for your questions. Senator Metzenbaum.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator Metzenbaum. I appreciate the chairman's courtesy. I am very pleased to see the Secretary again.

I do feel, I think it is important that we get some response and some indication of where the Treasury is going on the whole question of the subject called tax expenditures, which in many instances are tax loopholes. I know you are talking about a rather modest amount of money being closed up in that area. Actually, as I see it, without too much difficulty you could pick up about $50 billion in the next 3 years if you took some rather strong steps in that area.

What is concerning me, Mr. Secretary, is that there is a perception that first we had this hardnosed approach with respect to budget; now we are getting it with respect to taxes. And that is that there is sort of a feeling of it being against the individual, against the people, against the consumer. I know the Treasury, according to reports, is talking about liquor, and tobacco, and beer, and wine taxes, which all hit the small people of this country.

I think that there could come out of this whole movement—first we had the budget, now the treasury—sort of a feeling that the Government is mean spirited, that the administration is indifferent to average people. I think that the challenge is, frankly, yours to see to it that our tax program is not only fair and equitable but provides a degree of compassion to it as well.

I would hope that, as you speak today, you not only talk about not putting the burden on the taxpayers of this country but also concern yourself just about people of this country. And not increasing taxes in one department and increasing them in another is really doing exactly what you say in your last line you will not do, and that is placing the burden on the backs of the taxpayers. I think it winds up doing just that. I would hope we get some edification, some direction from you, particularly with respect to the subject of loopholes that you alluded to the last time you were here but said it was too early. Now I hope it will not be too late.

Chairman DOMENICI. Thank you, Senator. Mr. Secretary, you may proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman and members of the committee.

As you are all well aware, the economic goals of this administration and, I think, the majority of Congress are to eliminate inflation, reduce the size and scope of the Federal Government, and restore real economic growth. It is important to remember that there are four interrelated, mutually reinforcing components of the President's economic program. Each one has an important role to play in achieving our objectives.

Monetary policy has been stabilized and is generally moving in the direction that is necessary to reach our inflation goals.

Budget restraint and slower growth of Federal spending are essential to the encouragement of faster economic growth.

The recently enacted tax bill will provide a strong impetus for noninflationary growth of productivity, jobs, and real output.

A start has been made toward regulatory relief to insure that excessive cost burdens are not imposed on the private sector.

INHERITED ECONOMIC MESS CANNOT BE CURED OVERNIGHT

We are obviously impatient if we expect our program to cure decades of mismanagement overnight. The economic mess this administration inherited cannot be cured in 30 days.

Monetary restraint began only months ago. Tax relief began slowly on October 1 and will not reach major levels until next July 1. Spending restraint has been partially accomplished but further reductions are necessary.

Currently, there is a lot of attention being focused on the present poor performance of the economy, the unusually high levels of interest rates, and potentially large future budget deficits. The combination of these distressing factors has caused some observers to immediately declare defeat for the President's program. Such behavior is analogous to a grain speculator's announcing a crop failure while the seeds are still being planted.

We are dealing with the most complicated economy in the world and one that has been shaped by over two decades of deficit spending, inflationary expectations, and Government intervention. It is as if a tree had been grown with a wire bending it to the ground. After awhile, you can cut the wire, but the tree will not automatically spring up straight. It cannot. The trunk has been formed or deformed, and it will take time before normal growth patterns resume.

Interest rates have remained high. I would argue that much of the reason is due to the fact that investors' lack of faith in the Federal Government's ability to carry through a responsible economic program is more deeprooted than previously believed. Therefore, we must be even more determined to stand fast behind our policies in order to restore credibility to Government. Any indication on our part that we are willing to compromise on the President's program will only signal to the financial markets that it is business as usual in Washington and more inflation is imminent.

COURAGE TO SEE NEW POLICIES THROUGH IS THE QUESTION

The primary source of the uncertainty gripping the markets is this unanswered question: Will we have the courage to see the new policies through? Or will political pressures and rivalries cause yet another administration to back away from its chosen course before it has reached its goals?

The market's greatest concern is that, once again, shortrun considerations will derail a longrun program. If shortrun political or economic pressures divert Congress and the administration from working together on a sound national economic program for the 1980's, if press speculation on the state of the markets leads to pressure for economics as usual and politics as usual, then the markets will have reason to worry. The irony is that the worry would be a self-fulfilling prophecy.

Deficits are also still a major problem, but we have to recognize that as we succeed in reducing inflation—and we are—there is a period of time in which that very success contributes to the Government deficit. Why? Because as the rate of inflation drops, the immediate effect is a reduction in the growth of nominal tax revenue. The Government for more than 20 years has been using inflation to finance spending growth. As inflation declines, the Government can no longer rely on the automatic revenue increases that inflation generates to bail it out of the consequences of past spending excesses.

Thus, while we have already taken measures to reduce Government spending by $130 billion over the next 3 years and to cut Government's growth rate in half, the prospect of a recession means that the budget deficit may widen beyond our projection.

The index of leading indicators declined 2.7 percent in September, following a decline of 0.5 percent in August. This sharp decline in the leading index in September, along with a 0.5-percent decline in the coincident indicators for the same month, signals that the pace of economic activity is softening further from the sluggish pattern of recent months. The standard response to the six recessions this country has encountered since 1950 has been a lunge for the panic button, setting off what is now an all-too-familiar chain of events: increasing Government spending; enacting quickie, consumption-oriented tax cuts; pushing through a variety of Band-Aid-type programs for individual sectors of the economy; and encouraging the Federal Reserve to speed up the printing presses.

Such counterproductive measures are not going to be part of this administration's economic policies. That dreary set of events I just described are not part of a solution but the essence of the problem. Those knee-jerk reactions lie at the root of today's deep-seated, longrun economic problems. We know that, and we are not going to repeat them.

POWERFUL FORCES AT WORK

Thus, though I anticipate that there may be several more months of disappointing economic statistics, there are powerful forces already at work to transform current areas of weakness into sources of economic strength.

First and foremost, a powerful incentive and growth-oriented tax reduction is already in place. Consequently, the current recession will be mild, its end certain and swift.

A second powerful force working for a quick end to what will be a mild recession is the trend in interest rates. They are now coming down, particularly short-term rates. In some cases, such as commercial paper and 90-day CD's, they have fallen significantly from their earlier highs. Just yesterday, a major bank announced it lowered its prime rate to 17.5 percent. Lower interest rates will, of course, have a variety of positive impacts. More mortgage money should be available, with all that implies for residential construction and related industries.

There is no doubt that, as these forces make themselves felt, and as they combine with the four fundamental features of the President's program, 1982 and subsequent years will show vigorous, perhaps unprecedented, economic growth.

We will not relent in our effort to control the Federal budget. We will not relax in our determination to reduce the burden of taxes on the American people.

Those who suggest we should retreat from these commitments are wrong. We will not postpone or modify the tax rate cuts.

We are not going to balance the budget on the backs of the taxpayers.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Mr. Secretary. Mr. Secretary, in your statement you indicate that in the past when we have had recessions since 1950 there has been what you called a lunge for the panic button, increasing Government spending, enacting quickie consumption-oriented tax cuts, pushing through a variety of Band-Aid-type programs for individual sectors.

Mr. Secretary, I think that is a correct assessment, but I would ask you this. Do you hear any responsible people up here on the Hill suggesting that scenario at this time?

Secretary REGAN. Not at this time, Mr. Chairman. As a matter of fact, the argument has been going the other way.

Chairman DOMENICI. In fact, I would think the one encouraging thing is that that is not happening, at least as to those three. Nobody is suggesting more Government spending. Nobody is suggesting further additional so-called quickie tax cuts. I would hope you would consider at least that attitude to be encouraging from the standpoint of Congress. Do you?

Secretary REGAN. Yes, Mr. Chairman, and I hope Congress will not waver in that attitude as this recession may become more prolonged.

Chairman DOMENICI. As I read your analysis of where we are, you indicate that perhaps in the short run we are going to take in less revenue than anticipated because, as you put it, with inflation coming down, we are not getting the marginal increases in taxes. Do I read you correctly?

Secretary REGAN. That is correct, Mr. Chairman.

MONEY MARKETS WATCH PATH OF INFLATION

Chairman DOMENICI. Mr. Secretary, if that is the case, and not looking over a long period of time, but let us just say 3 years, 1982, 1983, and 1984, with reference to getting interest rates down and keeping them down, does it make any difference to the moneylenders of this country where that composite deficit comes from? You are just suggesting, without giving us any numbers, that perhaps the composite deficit, if I read you correctly, is somewhat larger—I do not know that you are prepared to tell us what; I will ask you in a minute—but somewhat larger than projected when the economic package was presented. Is that not correct?

Secretary REGAN. That is correct.

I think, Mr. Chairman, the direction of the deficits, and how we are arriving at them, is secondary. I think that what the money markets will literally be looking at is what is the path of inflation because, the path of inflation leads the interest rate curve. If inflation is going up, we are going to get higher interest rates. With inflation coming down, we are going to get lower rates of interest. I think that is what the money markets are literally interested in.

Now, to the extent that the Government is causing part of this inflation, they will be looking to see what the Government is going to do to stop that inflation. I think the whole thing is interwoven. The various components of it, while they can be singled out and examined individually, have to be put back very carefully so that you see the whole picture rather than just a part of it.

Chairman DOMENICI. Mr. Secretary, some of us have been led to believe that, in turn, the cumulative size of the deficit will have an impact on whether or not we are going to get inflation down and keep it down. Is that not correct?

Secretary REGAN. That can be very much a problem; if you have very large deficits, you will be eating up too much of the GNP with Federal spending and you will cause additional inflation.

GOAL IS TO REDUCE SIZE OF CUMULATIVE DEFICIT

Chairman DOMENICI. Mr. Secretary, we have to go to work here next week. We have to have a goal. I assume one of the goals—in fact, strike that. I assume the goal will be to reduce the size of the cumulative deficit between now and 1984. Do you not agree that we have to have that as our goal, the best way we can with reasonable projections to change what is perceived now as the cumulative size of the deficit?

Secretary REGAN. Oh, yes; you definitely have to be working to cut the deficits down to where they are absolutely zero at some time in the future and as quickly as we can to move toward that position in these next 3 years.

Chairman **DOMENICI**. Do you think then that we have opportunities to achieve that, based upon what you now know, by solely reducing spending?

Secretary **REGAN**. It is possible but not probable, Mr. Chairman.

Chairman **DOMENICI**. If it is not probable, then I assume you agree that we have to look at the revenue side to some extent in these deliberations?

Secretary **REGAN**. That is correct, Mr. Chairman.

Chairman **DOMENICI**. The President in his September 23 message suggested a mix that included some revenue enhancement. Has the administration arrived at a revenue enhancement package as of this time, Mr. Secretary?

Secretary **REGAN**. Not with any degree of certainly, Mr. Chairman. We have been looking at any number of things. We sent some tentative ones with a factsheet after the President's September talk. We have been discussing those particular items, not only with some Members of Congress, but also with the industries affected. But we have reached no conclusions at this time.

Chairman **DOMENICI**. Mr. Secretary, do you have an opinion as to whether or not we should attempt by whatever means possible to attempt to have an impact this year on that cumulative deficit? Or should we wait until next year?

Secretary **REGAN**. Mr. Chairman, that is a difficult question—it is a difficult answer; the question is easy. The answer is the one that is difficult for this reason. We are now just starting to get a look at where we may be going in the recession. Whether or not we should have massive tax increases in time of recession is a debatable topic. I think we all know that in fiscal year 1982 we have got to hold down the deficit just as much as possible. To the extent that we are not able to accomplish that by spending cuts and to the extent that we try to reduce that deficit by massive tax increases in the middle of a recession, this might be counterproductive.

So, at this point we are debating within the administration what is the proper course because of this change in the economic outlook.

Chairman **DOMENICI**. Mr. Secretary, $3, $4, or $5 billion in revenue enhancement in 1982 is not within your definition of massive, is it?

Secretary **REGAN**. Oh, no; that is well within the realm of probability, Mr. Chairman.

NO ECONOMIC FORECAST YET

Chairman **DOMENICI**. I have one last question. We have to open our deliberations in this committee, hopefully, next Wednesday or Thursday, with a thorough discussion of the size of the projected deficits in 1982, 1983, and 1984. Obviously, we have sources of information as to the spendout of our programs on the spending side, and we have estimates on tax revenues. But both are somewhat predicated upon economic assumptions. Mr. Secretary, do you have any present opinions, even if they are within ranges, of what we are looking at, in your opinion, for deficits in 1982, 1983, and 1984?

Secretary **REGAN**. All I will say at this point, Mr. Chairman, is we do not as yet have an economic forecast for the current year and a scenario for the outyears as an administration position. We have about five or six different ones that we are examining, ranging from very pessimistic to very optimistic. We are trying to draw a conclusion as to which among these is the most probable and the one that we think we should base our actions on. Until such time as we reach that conclusion, I am unable to answer you with any degree of positiveness. I would assume that we would have this, though, within the next several days; hopefully, we will be able to get a fix on this. As you know, by law we are supposed to have it in January, I believe, for publication.

What is happening here, Mr. Chairman, is that many of the outside forecasters—that is outside of Government—are changing their minds as to the outlook. Many of them are revising their previous projections downward. I suspect that the administration is going to have to do the same thing, revise our midsession projection downward; but to what extent, at the present moment, is the argument.

That, and what we see as the rates of interest and the rates of inflation will, to a great extent, influence those deficits in the outyears. You can get all the way from very small to very large deficits depending upon which assumption you take.

MOST FORECASTS ARE INCORRECT

I have to throw in this caution based upon 35 years in finance and working on a day-to-day basis with forecasts regularly in both the securities markets, commodity markets, and in the economy. Things seldom turn out the way you think they are going to. I have only to ask you to go back 2 years ago to November 1979 and think what you would have thought would be happening in November 1981 to see whether or not the scenario you might have adopted then would actually have happened today. The chances are that most forecasters will be wrong. Maybe for the right reasons, maybe for the wrong reasons, but the chances are the forecast will be incorrect. Therefore, I would urge that what you should try to do is to be reasonably certain about 1982 and take 1983 and 1984 with some healthy skepticism as to what might happen in those outyears.

Chairman DOMENICI. Well, I think your analysis and caution about the inaccuracy is correct, excepting my recollection would be in the last 3 or 4 years every time we have made them they have turned out worse, with the exception of unemployment, which we argued with; and it turned out unemployment was lower then. But, for the most part, we have a tendency, as do Presidents, to be optimistic.

COMMITTEE WOULD BE EXPECTED TO REDUCE REALISTIC CUMULATIVE DEFICIT

I have a last, hypothetical question. If this committee was to find that the realistic cumulative deficit is at least $240 billion over the 3 years, you would expect this committee and the Congress to take some action to reduce that. Would you not?

Secretary REGAN. Definitely, Mr. Chairman.

Chairman **Domenici**. Would you expect us to try to reduce it substantially, Mr. Secretary?

Secretary **Regan**. Definitely, Mr. Chairman.

Chairman **Domenici**. And, if that requires that we do some revenue enhancing, would you not find that that would be prudent economic policy at this point?

Secretary **Regan**. Fencing, as usual, with the word some, I would agree: with some revenue enhancement.

Chairman **Domenici**. Well, if we did all we could on the side of further curtailing the budget including entitlements, did all we could, would you suggest that we then look for the balance in some kind of multiyear enhancement package?

Secretary **Regan**. It depends, Mr. Chairman, on how you view the tradeoff between what you would have to do in order to get down to zero and how much that would require in the way of increased taxes and what those increased taxes might do to the tax cuts that are already in place and to the theory behind that. You would have to have a tradeoff in there.

So, I do not think there is a precise answer that can be given, but I would be glad to work with this committee and with the Senate Finance Committee to try to arrive at that balance.

Chairman **Domenici**. Thank you, Mr. Secretary. Senator Chiles?

SLOW MONETARY GROWTH NEEDED

Senator **Chiles**. Mr. Secretary, do you think the Federal Reserve has been too tight in its monetary policy?

Secretary **Regan**. Senator, I took particular note of your opening remarks. While there was some hyperbole in it—it is not every Monday, Wednesday, and Friday, because Paul Volcker and I have breakfast on Thursday—let me try to straighten the record once more as to exactly what I was trying to say and where we stand.

First of all, let us make the record clear. There is no quarrel between the Fed and the Treasury. We do see eye to eye on the need for slow monetary growth in the United States. We are quite satisfied with their self-selected targets for 1981.

My caution several months ago when this started was and still is: Don't undershoot your target. I was afraid then as I am afraid now that we are going to be in a recessionary period. If during a recessionary period the Fed were to step too hard on the money supply, you would exacerbate the recession. My caution was: Stick to your targets. And that is all I have been saying all along.

Senator **Chiles**. What about their target for 1982?

Secretary **Regan**. The target for 1982 which, as I understand it, is 2½ to 5 in M_{1B}, seems like a reasonable target.

Senator **Chiles**. Do you think the target for 1982, which would give a midrange of, say, 4 M_{1B}, is going to provide enough money growth to accommodate the growth that the administration is talking about? You are talking about revising your figures. I guess you have not revised them as of now.

Secretary **Regan**. Not as yet, no.

Senator **Chiles**. So, you are talking about a real growth of what in 1982?

Secretary **Regan**. We do not know with any degree of certainty. All I know is that it probably will be below the 3.4 percent that we projected in the midsession review. It will probably be two or slightly under, in that area, as it looks now.

That being the case, I would say that their target for growth of money supply will be sufficient; particularly as we have the tax cuts in place and we will be getting larger savings in a larger savings pool which can be used to help finance business, real estate, and other types of industries that will be looking for additional moneys in order to pull us out of the recession we are in.

FED SHOULD STICK TO TARGET

Senator **Chiles**. Well, the fact that the Fed is below their targets now on M_{1B}—I understand they are at the upper range of their targets on the other factor—do you think that they should loosen up now in order to hit their target?

Secretary **Regan**. No; I think they should stick to their target. That is what I am saying.

Senator **Chiles**. But should they loosen up the discount rate? Should they loosen——

Secretary **Regan**. To ease the money supply growth at this point would not be that helpful. We have not licked inflation yet. Inflation is still the number one problem in this country. Until such time as inflation and inflationary expectations are definitely killed, we are going to be in this constant cycle of up a little, down a little, up a little, down a little. That has been going on in waves now for the past 10 years. I think once and for all we have to kill that. For the Fed to really loosen money would be counterproductive to that fight at this time.

No, I am not saying the Fed should loosen money at this point.

HOUSING SITUATION CAUSES CONCERN

Senator **Chiles**. The next thing I was concerned about is the situation that we see ourselves in with housing. I would like to know why you think, if you do, that this is the best time to take a $21 billion cut in our off-budget credit financing. The major component of that, of course, would be housing. Agriculture would come along with that and small business.

Secretary **Regan**. From the point of view of housing, literally what we need are lower rates of interest. It is my judgment and the judgment of many people with whom I have spoken in both the thrift industries and in the housing markets themselves that, if we can get mortgage rates below 14 percent, if we can get construction loans in the 12-percent area, in through there, housing will again revive. These rates are within the realm of possibility in the near future.

Senator **Chiles**. The builders that I talk to now tell me that the only action that is around is Farmers Home. Some FHA has come down a little bit, so there may be a little there. But Farmers Home is the main thing that any small builder is finding.

If we make this cut in $21 billion on the off-credit financing, are not we going to destroy that?

Secretary **Regan**. I am not sure you will destroy it; you will cut it back. But at the same time, if that is part of the battle against inflation—and we think it is—and if that succeeds in helping to get interest rates down, you get a wonderful tradeoff there because the entire housing market will revive with lower rates of interest. And you certainly will not get lower rates of interest if you keep piling up Federal debt and have the Federal Government constantly in the market borrowing money.

This year Treasury has to refinance $250 billion and raise more—I do not know how much more; it depends upon what the deficit will be—plus this off-budget money. Let us suppose that the combination puts us in the $80- or $90-billion area. That means we are going to have to raise over $330 billion at Treasury to supply this. I suspect that this might tend to keep interest rates high, which would be counterproductive.

Senator CHILES. Do you think it is possible for us to balance the budget in 1984?

Secretary REGAN. It is, again, possible; but I think at this point I would have to add the same wording as I did to a previous question: but not probable.

Senator CHILES. Not probable.

Secretary REGAN. But possible.

Senator CHILES. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Symms?

ENTITLEMENT CUTS WOULD HAVE GREATEST PSYCHOLOGICAL IMPACT ON MARKETS

Senator SYMMS. Thank you, Mr. Chairman. Mr. Secretary, many of the Wall Street analysts, not all of them, but some of them are saying that in our overall budget picture we should reduce some defense spending. However, if you look at the analysis of the budget in the last 10 years, there really has been no growth, in fact a reduction in defense spending in terms of the entire budget. The percentage of the Federal budget has gone down in the commitment to defense.

The entitlement programs is the area where the big growth in Federal spending has gone.

In your opinion, which would have the greatest psychological impact on the markets and on the budget in the long run, the cuts in defense or reform of the entitlement programs?

Secretary REGAN. I suspect that cuts in the entitlement programs would be, given those two choices, the choice of most people in the money markets.

Senator SYMMS. That being the case, when do you think that we can expect to have enthusiastic support from the administration for those of us that are on this committee and in the Senate that believe that we should have done this in January but are still ready to do it in October and November or whenever, that we should reform the entitlement formulation and the timing of the payments, not reducing anyone's current benefits but making modest reductions in future benefits? When can we expect real enthusiastic support on this question from the President, yourself, and others in the administration?

Secretary REGAN. I would say that the administration will be coming back to this committee probably late next week again with more definitive ideas on how to achieve the reductions in these deficits which have been forecast.

NOT IN FAVOR OF REVENUE ENHANCEMENTS

Senator **Symms**. I appreciate that. I would certainly like to encourage you to encourage the President also to recognize that I do not personally believe it is in any conflict with anything that he said in 1980 during his campaign. Those of us that want to address this problem are saying that we want to make modest reductions in future benefit increases. I think that would be a way to guide us to a balanced budget. We could do it by 1984 without any new tax increases. I know the popular word is revenue enhancement; but, from my point of view, a revenue enhancement is a tax increase. That is an antisupply-side posture for people to be taking, to go back in and raise taxes; the people, after all, will have to pay them, and it takes money out of the private sector.

I personally will not be in favor of any so-called revenue enhancements until we can get the entitlement equation as part of that picture. I would really like to encourage the administration. I am sorry we did not do it last January 1981 or February, but it is never too late. I think personally that that would be the signal that the world is waiting for to see whether this Congress and this administration is for real: If we will tackle the 60 percent of the budget where the deficits are coming from.

I do not believe that it is true that the defense part of the budget is what causes us to have a deficit. We spent over half of the budget all through the fifties and sixties, most of the sixties, on defense and had much less, in the fifties no inflation, and real economic growth. It is since the age of entitlement programs that the Federal budget has gotten out of whack.

I think the quicker the President starts saying that on television to the American people the sooner we will resolve the problem here in Washington.

Secretary **Regan**. If I might just comment for a moment on so-called tax enhancements. What we have done there, the ones that we have surfaced, the ones that we are discussing among ourselves now are literally things that we think perhaps were unintended advantages in the tax code for certain industries. These were not fashioned that way by the Congress. These were interpretations that came about.

We are taking a second look at them to see whether or not, having given a massive cut, particularly to business, with ACRS and the like, whether or not these particular tax advantages at this point are necessary for business, maybe, if they are not necessary at this point, they could be eliminated and thereby more revenues gained for the U.S. Treasury without doing damage to supply-side economics.

HIGHWAY TRUST FUND COULD USE MORE MONEY

Senator **Symms**. Thank you, Mr. Secretary. I have one last question in the area of the Federal highway program. I noticed in the "Wall Street Journal" that it was reported that Secretary Lewis floated an idea of a 5-cents-a-gallon user fee increase on fuel a week ago. If this should come about, is it still the intention of the administration that any increase in user fees on fuel or excise taxes on batteries or rubber would still be committed to the highway trust fund and would not be considered for generation of general revenues?

Secretary **Regan**. Well, that idea has surfaced. It has not been discussed at any length in my presence at the particular moment. So, I am unable to answer your question on that, Senator.

I suspect that user fees are one of the things that we will be coming back with as part of our package. But I also suspect that, on the gasoline tax, if such a thing were to be put on, it would not be just for the use of the highway fund.

Senator **Symms**. I would certainly like to make a cautionary note to the administration that we certainly could use more money in the highway program all across the country. We have got bridges out of kilter all over the country and highways that are in a declining state. I would hope that the administration, in looking at that area, would try to keep that money dedicated to the highway fund, at least above 80 percent of any new revenue enhancements that might come in that direction.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you, Senator. Senator Metzenbaum?

Senator **Metzenbaum**. Mr. Regan, last April, when you appeared before the committee, you said that the tax shelters will no longer be needed because of the lower rates and investment incentives in the new tax bill. In the Wall Street Journal you said again that, when it is seen in its full flower, I think business will realize that it has such enormous tax breaks that many of the so-called loopholes are the type of things they will no longer need.

Business Week, on the very same day you were quoted as saying that, said that, far from snuffing out the tax shelter industry as many had expected, the new tax law, if anything, gives the shelter a hefty booster shot. It goes on to quote how the financial industry, your industry, has been selling shelters.

What, if anything, does the administration intend to do in order to cut back on tax shelters since it is obvious that they are being used, contrary to your representations?

TAX SHELTER WILL LOSE SOME ATTRACTIVENESS

Secretary **Regan**. Well, first of all, Senator, the tax shelter itself will not be nearly as attractive starting January 1, 1982, when that 70-percent rate, as you know, drops down to 50 percent for investment income. This takes away a lot of the tax attractiveness of these shelters.

Senator **Metzenbaum**. Let me point out that E. F. Hutton says that they will double the volume next year in tax shelters from $500 million in 1980, and I keep listening to E. F. Hutton.

Secretary **Regan**. Well, I suspect maybe you should ask them why then. I cannot answer for E. F. Hutton. Never will.

I would say, Senator, that, from the point of view of what they are talking about in terms of tax shelters, a lot of this has to do with the leasing provision of ACRS. And that goes corporation to corporation. That does not involve individuals. So, I suspect that a lot of the talk that is going on is in that area.

I do not know of anything new that we have done deliberately in the tax bill that will increase tax shelters as far as individuals are concerned.

Senator **Metzenbaum**. Do you intend to do anything about eliminating the leasing provisions of the ACRS in the new tax bill, which will cost the Treasury $12 billion in the next 3 years and about $30 billion by 1986?

Secretary **Regan**. We have just put out regulations concerning the leasing provisions. These were much stiffer than those people had hoped they would be, than most people were counting on, as a matter of fact.

I think that we now have to pause here to see, after people have looked at the IRS regulations concerning these leasing arrangements, what effect they are going to have. I would not want to forecast exactly what we will do until we see what the effect of the new regulations is.

MASSIVE CUTS WOULD BE GOOD FOR THE ECONOMY

Senator **Metzenbaum**. You could pick up about $50 billion in 3 years if you did something about the special tax breaks that the oil industry has, the new tax breaks you just gave to industry which will still cost about $12 billion, the tax credits for elimination of State exemption for windfall profits taxes, if you targeted industrial revenue bonds, if you eliminated bad debt deductions of financial institutions in excess of their actual losses, if you eliminated the capital gains on timber special treatment.

Is there any indication you are going to do any of these things? Or are you just going to do some of the so-called little piddling departments that may amount to $2 or $3 billion?

Secretary **Regan**. Well, you have to ask yourself, Senator, what is the economic effect of making those massive cuts.

Senator **Metzenbaum**. I have.

Secretary **Regan**. What were your results?

Senator **Metzenbaum**. My results were that it would be good for the economy and it would eliminate some of the inequities. It would make the people of the country feel that their Government was on their side. It would also, in my opinion, not affect the economy in any way because the oil companies certainly are the last part of our economy that need any economic assistance at this time.

MORE RIGS DRILLING BECAUSE OF INCENTIVES

Secretary **Regan**. Well, you understand that the recently enacted tax law and the oil provisions in it are not constituted for the larger oil companies; they are for the small producers in the United States. I submit that, since that legislation, we have had more rigs working. We have had more drilling. We have found more oil in the United States than we had a reason to expect, without this, would happen——

Senator **Metzenbaum**. Since the tax bill?

Secretary **Regan**. Yes.

Senator **Metzenbaum**. Since the tax bill there have been that many more?

Secretary **Regan**. Every rig in the United States is now in use and——

Senator **Metzenbaum**. They were——

Secretary REGAN [continuing]. As much as possible——

Senator METZENBAUM. That was decontrol accord—the first argument I got was that decontrol caused that; now it is the tax bill caused it.

Secretary REGAN. Both of them are causing it, Senator. After all, if you give incentive to people to do things, they will do them.

Senator METZENBAUM. But when decontrol occurred, everybody said all the rigs were working. Now you are saying all the rigs are working because of the tax bill.

Secretary REGAN. I am saying that we have given incentive to the small producer to go looking for more wells.

Senator METZENBAUM. Would you say that the small producers are those independents who are making hundreds of millions of dollars, as has been discussed on the floor of the Senate?

Secretary REGAN. No; I am not saying that. I am saying the ones that were affected by our tax bill that was just passed.

Senator METZENBAUM. Those were not the small producers only, Mr. Regan, and you know that. I mean, you cannot talk about Ashland Oil and some of the other companies that are making hundreds of millions of dollars and call them small oil. I am not talking about the 16 majors, but some of the small producers you talk about are extremely large segments of our American economy. And they were just given $33 billion back in that last tax bill by the administration's pressure to get its bid through.

Secretary REGAN. Remember, now, where that started.

Senator METZENBAUM. It does not matter where it started. As a matter of fact, it started with the chairman and the chairman of the Finance Committee in the Senate. And then we knocked it out in the Senate. It went over to the House. The House leadership started talking about $2 billion more. And you people came in with $26 billion more, which finally came down to $13 billion plus the $20 billion we had given. So, that is where it really came from. So, do not blame us for having started it.

Secretary REGAN. I am not blaming anybody, Senator, I am just reminding you of past action.

Let us take a look at what else you had to say about going back on tax cuts. If you want to tax more in the middle of a recession and take $50 billion of additional taxes in the middle of a recession, I am not sure that you are going to get the economic effect that you just stated your analysis would have us getting.

ELIMINATE CERTAIN SPECIAL TAX PRIVILEGES

Senator METZENBAUM. I am not saying tax more. I am saying the same thing as your answer to Senator Symms, and that is to eliminate those special tax privileges that exist and that are not needed in order to conform with supply-side economics but are just special inequities in the tax law. That is all I am talking about, not changing the whole concept of your approach.

Secretary REGAN. Well, to the extent that you do away with incentives in any one of the sectors, you are going to get less performance.

Senator METZENBAUM. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator.

I want you to know that I have been trying very hard, Senator Metzenbaum, to help you. I have been encouraging Senator Long to bring you onto the Finance Committee. He has regularly responded with great enthusiasm about the fact that you are on this committee.

Senator **Metzenbaum**. I am sure you share his view.

Chairman **Domenici**. Really, I do not want to say whether I do or not. [Laughter.]

Senator Quayle?

Senator **Quayle**. Mr. Secretary, do you think we will have a tax bill next year?

Secretary **Regan**. What type of tax bill are you referring to?

Senator **Quayle**. A tax bill. Are you going to push for a tax bill?

Secretary **Regan**. Yes; we will have a tax bill next year.

Senator **Quayle**. OK. And what will the tax bill be like?

Secretary **Regan**. Unfortunately, I cannot describe it in detail at this point. What it will probably consist of is a group of suggested changes in the Tax Code in order to close certain advantages that people have or that corporations have, in one area or another, in order to increase revenues.

Chairman **Domenici**. Would the Senator yield for a moment please?

Senator **Quayle**. On his time, I would be glad to.

Chairman **Domenici**. You will yield on my time; we will turn this light out.

Senator **Quayle**. Good.

THERE WILL BE A TAX BILL FOR FISCAL YEAR 1982

Chairman **Domenici**. Mr. Secretary, the question was, Are you going to have one next year? Now, the President, in his September 23 message, was not talking about next year; he was talking about this year. Is that not right?

Secretary **Regan**. I got a little mixed up between calendar and fiscal. For fiscal 1982 we will have a tax bill.

Chairman **Domenici**. The President was very specific. That package of $80 billion in deficit reductions including the enhancement package, and everything I have heard from the White House since, is that they want that done this year. Now, that is a tax bill of some type. I do not know how we find it. But is that not correct?

Secretary **Regan**. The President would like to see some type of tax bill this year, yes, in fiscal 1982.

Chairman **Domenici**. No; I do not want to let that go. I do not think that is what he said.

I would like you very carefully to tell us whether you are talking about these deficit reduction things that the President asked for, whether it was not his desire that we take action on them this year. And I mean this legislative session, Mr. Secretary.

Secretary **Regan**. Are you referring to the tax enhancements that the President suggested, the $3, $8, and $11 billion for each of the next 3 years?

Chairman **Domenici**. Yes, sir.

Secretary **Regan**. Yes; those will be up here this year, this calendar year.

Chairman **Domenici**. How about this legislative year? Is that what we are talking about, before we leave to go home this year?

Secretary **Regan**. We are saying the same thing. They will be up here.

Chairman **Domenici**. All right.

Secretary **Regan**. But I understood Senator Quayle's question to be a much larger one; in the sense of a large tax bill.

Chairman **Domenici**. All right. Thank you, Senator.

Senator **Quayle**. So, you will have before the Congress this year a tax bill that you will be pushing for which will, hopefully, be incorporated into the budget process and then eventually be adopted sometime next year by the Congress. Is that right?

Secretary **Regan**. Yes.

Senator **Quayle**. And that will be forthcoming, the details and the numbers—well, the numbers, I guess, are $3, $5, and $11 billion?

Secretary **Regan**. $3, $8, and $11 billion.

Senator **Quayle**. $3, $8, and $11 billion.

And that is basically what you are going to be talking about in your tax bill?

Secretary **Regan**. Yes.

LIMIT TAX RAISE TO $22 BILLION

Senator **Quayle**. There has been a lot of discussion here on the Hill that taxes would have to be raised to, say, $70 or $90 billion over the next 3 years. Let's see; $3, $8, that is about $20 billion or $22 billion over the next 3 years. That is about the benchmark that you are talking about.

You are not talking about any kind of a tax increase—excuse me, tax enhancement, of $70 to $90 billion?

Secretary **Regan**. No; I am not talking about that.

Senator **Quayle**. Would $22 billion be your outside limit?

Secretary **Regan**. That is what I am talking about.

Senator **Quayle**. Will there be any discussion to defer the income tax, the scheduled income tax of 10 percent next year and 10 percent the following year?

Secretary **Regan**. I would be adamantly opposed to that. I think that that would be counterproductive.

Senator **Quayle**. Would you be adamantly opposed to changing any of the tax measures that we just adopted?

Secretary **Regan**. No; I see no need to. I think, on balance, that was a good tax bill. I think it should remain in place and should be given a chance to work.

Senator **Quayle**. So, you do not anticipate during the next 12 months to go back and to say: whoops, we made a small mistake, whether it would be the income tax or the ACRS or something along those lines and try to refine that? You are going to go in an entirely new direction on your tax bill. Is that correct?

Secretary **Regan**. That is correct.

Senator **Quayle**. OK.

Mr. Secretary, in your statement, you said: "First and foremost, a powerful incentive and growth-oriented tax reduction is already in place. Consequently, the current recession will be mild, its end certain and swift."

PULLING OUT OF RECESSION SEEN BY MARCH OR APRIL

Then, I think, in responses either to Senator Domenici or Senator Chiles—and I wrote it down—you said that perhaps it may be more prolonged than anticipated. How long do you think this recession is going to be? Is it going to be swift and mild? Or will it be more prolonged?

Secretary **REGAN**. I think that we will be pulling out of this recession in the first part of 1982.

Senator **QUAYLE**. You think we will be pulling out of the recession in the first part of 1982. OK.

Senator **RIEGLE**. Would the Senator just pin down what is the first part of 1982?

Senator **QUAYLE**. January.

Senator **RIEGLE**. January? I did not hear him say January.

Senator **QUAYLE**. Oh.

Secretary **REGAN**. If we wish to be more definitive—and it is very difficult to be precise, as you know—I would say toward the end of the first quarter, the beginning of the second quarter of 1982.

Senator **QUAYLE**. March or April?

Secretary **REGAN**. In that area.

Senator **QUAYLE**. March or April. I thank the Senator from Michigan. We got a more exact statement.

Finally, Mr. Secretary, you said that it is possible but not probable to achieve a balanced budget. How important is a balanced budget to the economic recovery?

BALANCED BUDGET NOT PROBABLE WITHOUT HELP OF CONGRESS

Secretary **REGAN**. Well, first of all, let me explain that word probable. It is not probable without the help of this Congress to achieve further budget cuts.

Senator **QUAYLE**. So, you are betting that the Congress will not go further in the tax reduction? That is where you derive your probable assessment?

Secretary **REGAN**. That is trying to be realistic, Senator.

Senator **QUAYLE**. We appreciate that.

Secretary **REGAN**. Pardon?

Senator **QUAYLE**. We appreciate that.

Secretary **REGAN**. Trying to ascertain the effect of this, I think that, if we are able to achieve a budget that is on the way down, getting close to the balanced area, and if we can see ahead that this might be achieveable, and if at the same time—and I admit there are an awful lot of ifs here—inflation is down and, along with it, interest rates are down, I think that is what the economy is looking for. I think that is what the money markets are looking for.

I think it is more the direction and the trend than anything else because this trend has not yet been perceived.

Senator **QUAYLE**. But you think we can establish this trend and this trend could be perceived without actually achieving a so-called balanced budget by fiscal year 1984?

Secretary **REGAN**. I think that, if we are on the way there, coming close to it, and we do not—let's face it; at that point we will be in a $3.8 or $3.9 trillion economy. To state with precision we are going to get, you know, within plus or minus zero by that time is really very difficult to forecast. But I think the whole idea is that money markets are more sophisticated than that—they look at the trends and the direction and the attitudes. And I think that is what would be the most important thing to them.

OPPOSED TO CONSTITUTIONAL AMENDMENT TO BALANCE BUDGET

Senator **Quayle**. What is your opinion of a constitutional amendment to balance the budget, for example, saying that it would be in balance unless 60 percent of the Congress, three-fifths——

Secretary **Regan**. I think I would be opposed to that. I do not think that you could forecast that that would be achieveable, given the size of this Federal Government, with any degree of precision year after year after year. I think you would find yourself waffling and having to change the law.

Senator **Quayle**. Would it be helpful if we put off-budget items on budget?

Secretary **Regan**. Probably yes. But I would also say at this time, Senator, if I may, to make a plea for something that constantly puts us in a quandary. I know I am treading here into waters that perhaps I should not get into at this particular hearing, but why not.

Senator **Biden**. That's all right; the chairman will get you out of it.

Secretary **Regan**. I think that what we have to do is to be very realistic about the size of the debt and how we go about setting the size of the debt. And this idea of year after year coming back in and having to ask to have the debt ceiling raised, when we know darn well as a result of what we are doing with the budgets that we are going to create a larger deficit than currently is law, and then to play fun and games where we are trying to be professionals at the Treasury in managing our debt and in managing our moneys, I think it is something that I would hope the Senate might work on to come closer to the House's version during the current legislative year.

PUT OFF-BUDGET ITEMS ON BUDGET

Senator **Quayle**. You would rather put the off-budget items on budget?

Secretary **Regan**. I would like to. I think we ought to put the whole thing in there. Let us see once and for all what the Federal budget is.

As a matter of interest, do you know that, even if we balance the budget, you would still have to ask for an increase in the debt ceiling? In the case of the social security trust funds, Treasury has to sell them securities for the investment of the moneys that are collected for social security. If we had a perfectly balanced budget and $45 billion came in, let us say, as a figure for the year for the social security fund, we would have to sell them $45 billion of additional securities and increase the debt $45 billion merely because of that investment. We would have to come back up here and ask for an increase in the debt ceiling in a year in which you balance the budget. And I do not think that is logical.

Chairman **Domenici**. Senator, your time has expired. After you yielded to me, we started over.

Senator **Quayle**. I appreciate the indulgence of my esteemed chairman.

Chairman **Domenici**. Thank you, Senator. Senator Hart? Senator Biden?

Senator **Biden**. Thank you, Mr. Chairman.

I would like to make sure I understand, Mr. Secretary, about your assessment of what is logical and what is illogical. You told Senator Quayle that you expect the recession to continue to be in gear until the end of the first, the beginning of the second quarter before we start out next year. You have told Senator Metzenbaum that it would not be a good idea to stimulate the economy now in terms of either speeding up the money supply and/or additional tax cuts now.

You told us, I think, that at the very time we are going to be coming out of the recession is the very time that the big tax cut is going to kick in for the first time and that, in spite of that, our number one problem is inflation.

I am a little confused as to, if the logic applies in the first instance, why does it not suggest that, if we have a massive tax cut, a massive stimulus taking place in June of next year, a month or two after we have already come out of a recession, that that will not have an inflationary impact on the economy.

ADDITIONAL STIMULUS WILL COME FROM INDIVIDUAL TAX CUT

Secretary **Regan**. Well, I will try to make it a short answer, Senator. What you, first of all, have to remember is that, for the first 6 months of next year, most taxpayers in this country will be paying more taxes than they would be in 1981, and this is during a recession. It is going to be very difficult to find how that recession can end except through getting inflation down and interest rates down and the economy starting to regenerate itself.

With a kick-in of that individual tax cut on July 1 of next year, you will get additional stimulus, both in the form of savings and consumption. That will help to keep it going. And my suggesting that we will be——

Senator **Biden**. And it will not be inflationary?

Secretary **Regan**. In my suggesting that we are coming out of the recession, you do not come out of the recession with the nose straight up. You come out on a gradual plain. And this will help it to go and will be noninflationary. No, it does not have to be inflationary.

Senator **Biden**. It does not have to be inflationary, OK. That is interesting.

Secretary **Regan**. Tax cuts do not have to be inflationary, Senator.

Senator **Biden**. No; I guess not. I guess that deficits do not have to be inflationary sometimes. A lot of things do not have to be inflationary, but the trend has been that they tend to be.

Secretary **Regan**. A lot depends upon your monetary policy and the way that you handled your money alongside what is happening in the fiscal area.

Senator **Biden**. I do not disagree with that. But I just for the life of me cannot understand why—well, my 5 minutes are going to be up before I get to the next question.

DEFICIT INCREASE DUE TO REDUCTION IN INFLATION

You said something else in your statement, that the increase in the deficit, the increase above what you thought it would be, I thought you said, is due in part to the reduction in inflation as a consequence of the Government getting less inflated dollars back, fewer dollars back, because it is not benefiting as a consequence of inflation.

Is that the bulk of the reason for the increased estimates of the deficit? I mean, how much of that is attributable to a lessening of inflation, your deficit reestimates?

Secretary **Regan**. Well, again, it will depend. Here we have to be talking about the out-years, 1983 and 1984. You have to be talking in terms of what scenario you are going to be following out there as to what is the rate of inflation, what rates of interest are you considering, and so on. If you consider that we will still have relatively high rates of interest, the effect on carrying the debt would be to increase the cost and would increase the size of the deficit.

If you have much lower inflation and you get reasonable real growth, the effect on nominal dollars is that Treasury receipts will be way down. This is always the way that it happens because you do not get bracket creep, things of that nature.

So, quite a bit of your deficit will be, curiously enough, from the good effects of getting inflation down.

Senator **Biden**. You say quite a bit. Are you talking—we are talking about massive reestimates. We are not talking about a billion here and a billion there, as Senator Dirksen allegedly said: It begins to add up. We are talking about tens of billions of dollars.

Secretary **Regan**. I have seen some figures that indicate better than half of your deficit will be as a result of lowering inflation and, therefore, lowering Treasury receipts.

INFLATION PROJECTIONS LOWERING

Senator **Biden**. Are you lowering your inflation projections?

Secretary **Regan**. Are we lowering them? As I said in answer to the chairman's questions earlier, we have not come up with our official reforecast at this time. But even the most pessimistic as well as the most optimistic do show a lowering of inflation from the midsession review projection.

Senator **Biden**. How do you arrive at the judgment that this reestimate of the deficit, which you have done, is attributable, significantly attributable to a reduction in inflation if you have not reestimated your inflation figure? I am confused.

Secretary **Regan**. I said that we had reestimated the inflation figures in most of these scenarios. And as you look at that, as you see the deflator down and staying down, which it seems is the most likely course of action now for both 1983 and 1984, you do get a tremendous reduction in Treasury receipts.

Senator **Biden**. When you say tremendous, it——

Secretary **Regan**. It is in the billions, tens of billions of dollars.

Senator **Biden**. Tens of billions of dollars.

I see the red light is on. I will wait until the second round. Thank you.

Chairman **Domenici**. Thank you, Senator. Senator Hart? Senator Riegle?

Senator **Riegle**. Thank you, Mr. Chairman. Mr. Secretary, almost every day we pick up the business page of any major newspaper in the country, and it is a deluge of bad news. I do not have here with me the front page of the business section in yesterday's Washington Post, but it was one horror story after another in terms of the picture in the auto industry or with the S. & L.'s or with our trade deficit and other items of that kind.

I would just like to make an observation, and then I would like to ask you to respond.

ECONOMY IN VERY SERIOUS TROUBLE

I think the economy at the moment is in very serious trouble. It is very uneven. There are some sectors that are in desperate condition, and there are others that, as you say, are like the oil industry that at the moment is doing quite well.

I think your interest rate policy is caving in the economy. I think it is caving in the auto industry. It is caving in the thrift institutions. It is caving in large parts of agriculture. I hear this from my colleagues across the country. It is caving in small business. You seem to have no remedy for that. I speaking now generically. The administration seems to have no remedy for that.

I cannot for the life of me understand why you are holding to this high interest rate policy at this time, when you have got major economic sectors that desperately need credit. They desperately need capital. They need interest rates they can afford to pay. You are withholding that from them. You are saying basically that you are not going to respond to that problem.

The situation is getting worse by the day, and I do not understand that. I would like you to tell me why it is you are holding to this high interest rate policy.

Secretary **Regan**. Well, high interest rates are the symptom that comes along with the disease. The disease is inflation. As you know, last year inflation was running at a 13- to 14-percent range. This year, in terms of the CPI, even in the third quarter we again went back into double digits. I do think that we will be back into single digits in this quarter. That means that we have not eradicated the problem at all. This is a very serious problem not only for our Nation but for nations throughout the world.

We have to get rid of inflation. There is no easy way out of it, it is so ingrained in our system at this point, Senator. It has been there now for years. To try to get it out quickly or, having gotten it out in part, to suddenly change course would be counterproductive, in my judgment, at this time. So, we have to stay on that.

Now let us talk about interest rates themselves. As inflation comes down, obviously interest rates are coming down with them. Interest rates did probably peak in the August and September period, and they are off considerably from that. Most are off 2- to 3-percentage points. The prime, for example, is down from 20.5

percent to, at least in several banks, 17.5 percent. In the case f the Treasury bill rate, we were paying close to 16 percent just a couple of months ago. Yesterday, Treasury bills were at 13.04 percent.

BANKRUPTCIES MOUNTING

Senator **Riegle**. Let me just stop you. Here is the problem that is happening. We have got a mounting cascade of bankruptcies that are taking place in businesses of all sizes but particularly among small business. I think very shortly we are going to see some major bankruptcies or the likelihood of some major bankruptcies among some larger firms.

I am just saying that you are not getting them down quick enough. Now, one of the reasons you are not is that there is not enough credit to go around. The Federal Reserve has been very tight with the monetary policy. Paul Volcker yesterday was before the Banking Committee. His target for M_{1B} for the year has been 3.3 percent, and the actual performance has been at 1.1 percent. That is how far off target they are.

You have got these major merger efforts and these corporate takeover efforts that are sopping up tens of billions of dollars of what credit there is. The people who need it to survive—and I am talking now about small business, the auto industry, agriculture, the construction industry—are dying. I just do not understand how you can respond by saying that that is the medicine that we have to take. If it is going to kill those patients and cave in that part of our economy, how can we possibly hope to come out ahead?

I do not understand how you can cripple and, I think, permanently damage major sectors of this economy with this high interest rate policy and ever hope to come out ahead. I just do not understand that.

Secretary **Regan**. Well, we are not deliberately trying to cripple any sector. We are very sympathetic to these industries. We wish we could reduce interest rates faster. We do not know how to do it faster except to pump in more money. Certainly, if you pump in a lot more money, you are going to get inflation back again——

Senator **Riegle**. Let me give you a suggestion if I may.

Secretary **Regan**. Certainly. I would welcome it.

GIVE INDUSTRY DIFFERENT SIGNAL

Senator **Riegle**. I think there are some things we can do. First of all, I think the Fed can get within its targets in terms of money growth. I think the President needs to say that. He is not saying that. In fact, Volcker yesterday indicated that the Reagan administration supports exactly what the Fed is doing. I think you have got to give them a different signal. I think the President has to do it. The time is now for that to happen.

I also think you are within your rights to ask that these major billion-dollar allocations of credit for mergers and for corporate takeovers and so forth, that that be put aside for now. That is not what this country needs. That is not restoring jobs. That is not revitalizing the economy. There is no supply-side thrust in that. And why not say so? Why not come right out and say so? Why don't you put your foot down? Why does not the President put his foot down in this area?

The unemployment rate is rising at the present time. For every 1 percent increase in unemployment you are going to see the deficit balloon here by about $30 billion. I think that does matter. I think we do have to get the deficits under control, but we cannot begin to do that if you do not get these rates down and get some credit into these credit-starved sectors.

You are going to have to do it. You are either going to have to do it with jawboning, or you are going to have to use some form of credit targeting. Now, I do not understand why you are reluctant to do it.

I mean, I have got to believe that you see the damage even if others do not.

Secretary REGAN. Well, first of all, Senator, when you talk about these massive takeovers and the credit allocation there, look what happens to that money. The money is borrowed, certainly, but then it recycles itself. Who does it go to? It goes to the stockholders or to the bondholders of the company being taken over. They, in turn, have to do something with that money. They reinvest it. So, the money does get recycled.

So, to the extent that there have been these takeovers—and most of the takeovers are not for cash, by the way; they are usually stock swaps, something of that nature. And there you are just exchanging pieces of money.

INDUSTRIES LOSING MILLIONS

Senator RIEGLE. Let me give you some numbers just on the auto industry. General Motors reported a quarterly loss $468 million. The Wall Street Journal says that the actual operating loss was closer to $900 million. That is for 90 days. That is losing $10 million a day.

Ford reported this week a $334 million loss. Chrysler reported yesterday a loss of $149 million.

My question to you is, how long can that go on? I mean, you are a practical person in terms of having lived that in this world of high finance and economics. You know as well as I do there is no way that can continue for more than a few more weeks before we are going to have disasters on our hands all over the place. It is in the farm equipment industry as well as the auto industry and in a host of other areas. Somebody has got to blow the whistle, and I think you are the person to do it.

Secretary REGAN. Well, I think that what we have to do, of course, is to get interest rates down. But you do not get interest rates down by merely insisting that we pump more money into the economy. As the markets now stand, if we were to pump a lot more money into this economy, everyone would believe that we had given up on the fight on inflation and that we are going right back to where we were.

FISCAL TIGHTENING NEEDED

Senator RIEGLE. I am not suggesting that is the only thing to do. I think that has to be done, and that has to be done urgently. I think at the same time we need fiscal tightening. We have got sacred cows in this budget that you know that we have not taken a budget knife to: the massive increases in defense spending, the tobacco subsidies, the western water projects, the Clinch River breeder reactor. The budget is loaded down with items that need to have the knife taken to them.

We need some fiscal tightening. I think maybe that even includes—you talk about revenue enhancement. I do not know where the words "tax increase" went to. I mean, that is obviously gimmick language. If you want to use it, that's fine; I do not think you are fooling anybody. But I am in favor of seeing additional fiscal tightening as a tradeoff for monetary easing, but you have got to get it soon. If it comes in 6 months, if it comes in the first quarter of next year, that is not goinq to work; and you are going to have this thing caving in on us in a way here where there is going to be massive damage to the national economy that is going to be on our backs for years and years to come.

I have to believe that you see that risk.

Secretary **Regan**. Well, I see the risk, obviously, Senator, but I also wish you well in getting these budget cuts through. I think that is one of the reasons the chairman has me here today, to make certain that we are all singing from the same hymnal.

Senator **Riegle**. But here is the problem that we face. Even the Republicans now, even the Republicans who were supporters of the President have not been able to agree on the strategy for the fiscal tightening. Of course, that party is in control here, and it has very great strength in the House; and there is not agreement on that side.

INTEREST RATES CANNOT WAIT

What I am saying is the interest rates cannot wait. I do not think it is sufficient for you to stand off to the side and say all these bus:iness failures and all this tremendous damage has to go on because we are powerless to do anything. I think you need a response on the monetary side now. I think you are going to have to do something to bring these rates down and bring them down within the next several weeks. More than that, I think you are going to have to go beyond to some form of credit targeting. There are different approaches that have been used in the past. People even like Arthur Burns have not been averse to doing that in the past when it was needed to get money into credit-starved sectors. I think you have got to face that problem.

I think it is a transition problem. We have got these enormous international economic changes that we are adjusting to. But we have got to get through this transition. I think you have got to be more flexible. I think you have got to respond to that problem while you still have time to do it.

Secretary **Regan**. My only caution there, Senator, is to recall what happened about a little over a year and a half ago in the early part of 1980, when we suddenly lurched into credit controls. We almost blew the economy right there and had to undo them again within a period of a couple of months. I would be very reluctant to intervene in the marketplace.

Senator **Riegle**. My friend, look——

Chairman DOMENICI. Senator, the last question, please.

Senator RIEGLE. All right.

Today we have got credit allocation. We are rationing credit by price. If you can afford to pay the high rate, you get the money. The oil companies and some others who are in very strong financial position right now, they can get, really, all the money they need. We are seeing it in these takeover bids, these corporate raids, and so forth.

The problem is that most of the economy that desperately needs the money to finance working capital, to stay in business, plant modernization, productivity improvement, cannot get the money because there is not enough and they cannot afford to pay the rates. Frankly, what I am hearing you say today is that there is really nothing you can do about it, that that is part of the pain we have to suffer, and that damage is just something that the Reagan administration is prepared to accept.

LET FREE MARKETPLACE WORK

Secretary REGAN. I would not agree with that, Senator. I think that what we are doing here is saying let the free marketplace work. It always has worked in the past.

Senator RIEGLE. Well, Mobil announced today——

Secretary REGAN. We do not think that Government controls are the answer.

Senator RIEGLE [continuing]. Mobil today announced its takeover bid for Marathon Oil. Is that your notion of the direction the country needs to take right now? Does that really go to the heart of our economy problems? Is that what you want to say to unemployed people? Is that what you want to say to these sectors that are in distress, that the money that they need is going to go for this kind of activity? I hope that you can do better than that.

Secretary REGAN. Well, wait a minute. Where is the money coming from that Mobil is using?

Senator RIEGLE. That is a very good question.

Secretary REGAN. Is it a stock swap? I do not know the terms. It has just been announced. If they are swapping stock, what is the effect on the credit market?

Senator RIEGLE. Well, the lines of credit that have been lined up by the oil companies: Texaco, $5.5 billion; Conoco, $3 billion; Cities Service is $4 billion; and Mobil is a $6 billion figure, $5.7 billion, just short of $6 billion. I mean, this is on-the-shelf credit, my friend. This is money that small business people across this country desperately need. They need it on Main Street in every city and every State in this country, and they are not getting it.

I think you are enough of a free enterprise advocate to understand that there has got to be some equity and some balance. You just cannot take care of the big guys and let everybody else go down the drain.

Secretary REGAN. Well, we are far from that, Senator. You would have to say that there was not enough credit to go around——

Senator RIEGLE. There is not enough credit to go around. That is exactly the problem.

Secretary **Regan**. I am suggesting there is. There is plenty of credit available, but in the fight against inflation——

Senator **Riegle**. At prices people cannot afford. That is the problem.

Secretary **Regan**. Prices are high. But would you trade that off for inflation?

Senator **Riegle**. I do not think that is the choice.

Secretary **Regan**. I think it is, Senator.

Senator **Riegle**. Well——

Chairman **Domenici**. Senator, I have got to go to the next Senator. We have already lost Senator Hart because he could not wait.

Senator **Riegle**. I understand.

Chairman **Domenici**. Mr. Secretary, even though it is not within your prerogative, do you have the capacity to perhaps send to this committee in the near future an analysis of this merger issue? Obviously, we cannot do much about it on this committee, but it appears to me that we ought to put it into some kind of historic perspective so Senators like Riegle and others will know what it looks like compared to the last 10, 12 years. I mean, we have had mergers all the time. When we had much less of an economy, we had short supply of money, and we had mergers. I wonder if we could not just over 10 years list in some quantitative way what mergers look like in terms of money, use of money.

Who does that? Justice?

Secretary **Regan**. Well, Justice would probably keep track of it. Commerce would also have an area to play. But I think we can get them together since you are asking me. We will get the figures together and submit them to you.

Chairman **Domenici**. I think it would be helpful.

Secretary **Regan**. My inquiry was as to whether we had started any such study in Treasury yet, and I am informed that no one knows of such a study being underway. So, it may take us a couple of weeks, but we will be more than happy to submit it to you.

Chairman **Domenici**. Thank you, Mr. Secretary.

Senator Sasser, could I ask on his timing and your timing here? I understand, Mr. Secretary, you have a 1 o'clock appointment.

Secretary **Regan**. I do.

Chairman **Domenici**. We have Senator Sasser. Senator, did you want to inquire?

Senator **Grassley**. I do not think so.

Chairman **Domenici**. I just want to ask the Senators now. Would 15 minutes be adequate for the rest? Or would you like the Secretary to try to arrange for some additional time?

Senator **Biden**. We are going to have 15 minutes for question and answer or 15 minutes or listening?

Chairman **Domenici**. To him?

Senator **Biden**. To you.

Chairman **Domenici**. I have taken 2 minutes, Senator Biden. He will stay to 2 minutes after 1 o'clock if you want to argue about that.

Senator **Sasser**. I will not take over 5 minutes, Mr. Chairman.

Chairman **Domenici**. Well, let us gamble here and think that we can get it done. Go ahead, Senator.

FEDERAL RESERVE SHOULD STAY WITH TARGETS SELECTED

Senator SASSER. Thank you, Mr. Chairman. Mr. Secretary, David Stockman appeared here before this committee 2 weeks ago and testified. I was very depressed when he got through. He commended the Federal Reserve Board for its continued progress in reducing the rate of growth in the Nation's money supply. Well, there was a ray of hope just a day or two later because I read where the Secretary of the Treasury, Mr. Regan, had said, and I quote: "The Federal Reserve Board should not stay in a low-money-supply mode any longer than is necessary in the downturn."

Now, that sounded to me like the administration was getting ready to do something about interest rates. My question to you, Mr. Secretary, is this administration now ready to jawbone the Federal Reserve Board and do something about increasing the supply of money so we can get interest rates down?

Secretary REGAN. Senator, I answered this once before, and I will try to——

Senator SASSER. Well, I got here——

Secretary REGAN [continuing]. Make certain that my answer is in harmony with my previous answer.

Senator BIDEN. The chairman will straighten it out if it is not.

Secretary REGAN. Thank you, Senator.

What we are saying to the Federal Reserve is this: You have selected the right targets. Stay with those targets. Try to hit those targets.

In a recessionary period such as we are in, it is not the right thing to do to miss those targets on the downside because you are apt to exacerbate a recession if you do not have enough money supply.

On the other hand, we are definitely not saying to the Federal Reserve: Pump in a lot more money. We do not believe that that is necessary or would be the wise course at this particular moment.

UNCERTAINTY CAUSING INTEREST RATES TO RUN HIGH

Senator SASSER. Mr. Secretary, I have never understood how you are going to run an economy here with a very restrictive monetary policy being practiced by the Federal Reserve Board and a very stimulative fiscal policy being practiced by an administration that has proposed to this Congress and gotten passed one of the most massive tax cuts in the history of this country.

A very distinguished economist characterized this economic conduct as an individual trying to go up and down the stairs simultaneously; it just cannot be done.

You have said, in response to Senator Riegle's questions, that the real culprit in the interest rate situation is inflation. But traditionally in this country interest rates have run about 2.5- to 3-percent ahead of the rate of inflation. Well, my goodness, now we see interest rates running anywhere from 6 to 8 to as high as 12-percent ahead of the rate of inflation. When we talk about the Fed hitting their targets, I do not know whether they are hitting the target they intend to hit, but the targets they are hitting—and you know this as well as I do—the homebuilders and the auto dealers, to small business people—in my State of Tennessee, unemployment has now taken the lead in the polls as to the principal issue. It is no longer inflation. It is unemployment.

I come from a semiagricultural State. The unemployment rate there is running higher than the national average. The reason is interest rates.

My question to you is this: Why are we in a situation now where interest rates—I am talking about real interest rates corrected for inflation—why is it running two, three, four, or five times higher than it has traditionally done?

Secretary **Regan**. The short answer—and there can be a much longer answer, time permitting—is the uncertainty that the money lenders of this country have as to whether or not this Congress and this administration will stay the course and will get inflation down. The uncertainty breeds this unusual premium that is being demanded, primarily in the short term. If you look at long-term rates of interest, I think that they probably are in line with some people's expectations of what inflation is going to be, plus the normal premium. I do not agree with that, by the way, because I think we can get inflation down.

The unusual premium is also declining at this moment. During the month of October it came down rather rapidly. I suspect that, as they see this Congress try to close the budget gap, that we will try to spend less at the Federal level, that we will try, over time, to come up with a balanced budget, I think you will find that the uncertainty will come out of the picture and that that unusual premium will go back to its normal course.

GREAT BRITAIN TO STAY THE COURSE

Senator **Sasser**. Well now, Ms. Thatcher in Great Britain has indicated that she is going to stay the course. She has been staying the course to the extent that they have the highest unemployment in Great Britain since the Great Depression. In fact, the last figures I saw, unemployment in England was higher than it was during the Great Depression. Yet, we do not see any significant drop in interest rates there.

Secretary **Regan**. Well, there has been a significant drop in British interest rates, some 5 or 6 percentage points. I think to try to compare us with Great Britain is not a valid comparison inasmuch as——

Senator **Sasser**. I would agree with that. I am talking about staying the course, though, Mr. Secretary.

Secretary **Regan**. Well, as far as staying the course, obviously, if she stays long enough, her program will probably win. And I cannot get into the politics of this because I am not a politician.

Senator **Sasser**. Well, I will tell you this. I do not think she will stay beyond the next election.

Mr. Chairman, my time is up. Thank you.

Senator **Riegle**. I notice you said probably, too.

Secretary **Regan**. Pardon?

Senator **Riegle**. I notice you said probably, that she will probably win. That was less than a certain——

Secretary **Regan**. Very little is certain in life, as you know, Senator, except death and you know what.

Chairman **Domenici**. Death and lower taxes, Mr. Secretary.

Secretary **Regan**. Yes, Mr. Chairman. [Laughter.]

Chairman **Domenici**. Senator Grassley?

BEING ON COURSE IS STRENGTH OF PRESIDENT'S PROGRAM

Senator **Grassley**. I do not have a question. I just want to say that the worst thing we could do is change the course of direction at this point. In past administrations, we had many situations in which a policy would be announced and backed away from. I think the strength of the President's program, with your support, is the fact that it has been on course ever since he was sworn into office. I just beg you to keep that course and don't say anything that is going to cause anybody in the country to think that there is any detracting from that.

Secretary **Regan**. Thank you, Senator. We intend to.

Chairman **Domenici**. I had one or two more questions. Senator, do you have one more question?

Senator **Riegle**. I think under the time pressures that exist that I do not know that we can get very far. If the chairman has something he wants to nail down, he was gracious to me before; let me be gracious in return.

Chairman **Domenici**. There is a vote on the Mattingly amendment.

Let me ask this last question, Mr. Secretary.

I have already laid the proposition before you that, even if we do not know precisely what the deficits are in 1984 and might not even know what they are in 1982, because of our inability to come up with exact economic assumptions and other assumptions in a budget, but I have suggested that there is no doubt that the cumulative deficit over the 3 years is much higher than we had anticipated. I use the $240 billion composite. I think that may be low. Let us just use that hypothesis for a moment and ask you.

It has been my belief that the most significant thing we could do to alleviate the high interest rates and the economic situation is to at the earliest possible date reduce permanently that composite deficit, whether it is the figure I gave you or higher. That to put in place measures that will substantially reduce that composite is an appropriate response to the present economic problem. I would add to that: it could be done without altering the 1982 tax program in terms of incentives for growth and investment.

Adding that to my statement, would you agree that that is what we should set out to do, Mr. Secretary, what I just described?

Secretary **Regan**. I would agree with that, Mr. Chairman. I think that fiscal responsibility has to go along with the monetary plan. It has to also be a companion to what we are trying to achieve here as far as incentives for people and for industry to get back to work, to do more and increase our productivity. So, I think you are on the right course, Mr. Chairman.

TO SHOW CONTROL IS IMPORTANT ISSUE

Chairman **Domenici**. We have been told by most of the economic experts that came before us that, even if you do not have a predicted exact balanced budget, the important issue is to show to the American people that we have better control over the deficits in

1982, 1983, and 1984 than has been historically the case. Is that what you were saying?

Secretary **Regan**. Yes. As you recall in my answer to Senator Sasser as to why we have these unusual real rates of interest, I said it was uncertainty over whether we would stick with it and whether we could get these things under control.

Chairman **Domenici**. So that, aside from your concern about how we do it in terms of the tax package, you agree that a major congressional approach should be to reduce the deficits that are predictable, with whatever variance; plus or minus $25 billion may be the new test. If we look back, that may have been an appropriate test heretofore. Two or three years out, you cannot predict any closer than $25 or $30 billion. But, even with that inability, you agree we must address that composite deficit in a meaningful way as quickly as possible. Is that correct?

Secretary **Regan**. I agree with that, Mr. Chairman, yes, very definitely.

Senator **Biden**. Keep 'em close, Mr. Secretary.

Chairman **Domenici**. All right, does anybody else have any questions?

Mr. Secretary, we thank you very much for accommodating us.

Secretary **Regan**. Thank you very much, Mr. Chairman.

Chairman **Domenici**. We stand in recess.

[Whereupon, at 12:55 p.m., the committee was adjourned.]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
FISCAL YEAR 1982 BUDGET
for the
SENATE BUDGET COMMITTEE
by
DR. JACK CARLSON
September 24, 1981

On behalf of the 700,000 members of the NATIONAL ASSOCIATION OF REALTORS® I would like to update our views on spending and taxing policies which we presented on April 6, 1981, to help assure improvements in the economy, especially lower interest rates, urgently needed now for housing and other interest-sensitive industries.

We congratulate the members of this Committee and the other members of Congress who have taken the difficult actions to slow the growth in spending in many federal programs and slow the growth in taxes. However, tax relief was larger than spending reductions and has led to higher interest rates.

RECOMMENDATIONS

We recommend:

(1) The President and the Congress should make good on their commitments early this year to hold spending to $695 billion for FY 1982, instead of busting the budget by $10 billion announced by the Administration in July, another $10 billion in the appropriations process in the Congress and as a result of bad estimates.

(2) If spending restraint proves unlikely because of inadequate leadership or courage to trim defense, non-defense and/or entitlement programs then the across-the-board 10% personal income tax rate cut scheduled for July 1, 1982, should be deferred for 90 days until October 1, 1982, and the same action may be needed on the July 1, 1983, tax rate cut.

(3) Whether by spending cuts or tax relief deferral, the deficit should not exceed $42.5 billion in 1982 and decline in 1983 to a balance in 1984.

(4) We urge the Congress to encourage the Federal Reserve Board (a) to allow the growth of money to achieve the mid-point or upper-end of their targets instead of below their target; (b) to adopt a secondary interest rate target range, such as 13-16% for short-term rates, to reduce excessive fluctuations which alone have accounted for one-fourth of the decline in the interest-sensitive sectors of the economy.

(5) We urge the President and the Senate to appoint and confirm a qualified small businessperson from the interest-sensitive industries as the next replacement to the Federal Reserve Board, expected January 1982.

(6) We urge the Congress to insist upon implementation of the All Savers Certificates including the Congressionally mandated tie that three-fourths of the net funds go for housing and agricultural loans (see Attachment 1 for potential benefits).

These recommendations are our extension of those we made to you earlier this year with the concern that if a similar approach was not accepted, rates would be higher, and unfortunately that is what has happened. Our earlier recommendations included:

- tax relief no greater than spending cuts so that the federal deficit would trend downward each year towards balance in 1984
- limit across-the-board personal income tax relief to keep the deficit from rising.

Since that time -

- greater tax relief was enacted than spending reductions, causing the federal deficit to increase not decrease and set record interest rates
- monetary policy has not been eased significantly.

As a consequence the interest-sensitive sectors of the economy are being crippled five times more severely than at any other time in the past 40 years. For example, conditions in the housing industry are severe. The 34 month old housing recession is not only the steepest but also the longest housing downturn since statistics have been gathered on the resale market (see Table 1).

TABLE 1

PERIODS OF DECLINE IN EXISTING HOME SALES
(Seasonally Adjusted Annual Rates, Millions of Units)

Housing Recession	Peak	Trough	Date of Recovery to the level of Prior Peak	Percent Decline Peak to Trough	Total Duration Peak Through Recovery
1969-1970	Dec. 1968 1,710,000	Mar. 1970 1,370,000	Aug. 1970 1,720,000	-20%	20 months
1974-1975	Feb. 1973 2,500,000	Jan. 1975 2,040,000	Sept. 1975 2,600,000	-18%	31 months
1979-?	Nov. 1978 4,020,000	Aug. 1981 2,260,000	?	-44% ?	34 months so far

Source: NATIONAL ASSOCIATION OF REALTORS®

The housing industry is currently suffering from the deepest recession in post-war history. Housing starts are at a 0.937 million unit annual rate currently, and expected to average only 1.2 million units for 1981 -- virtually the same as last year. We expect only 1.5 million starts in 1982 and 1.8 million starts in 1983. Since the underlying demand for replacement and new housing is about 2 million units per year, housing supply is expected to continue far below the underlying housing demand. The implication is for housing to be in short supply throughout the 1980's as industry capacity will not be able to both supply the growing needs of expected demographic demands and the left-over unsupplied demand of the current housing recession. This will only add to future increases in housing prices and rents, and increased upward pressure on the long term rate of inflation.

Resale activity has also dropped from its November, 1978, peak of 4.02 million units to a low in August 1981 of 2.26 million units (see Table 1).

While we have come to regard widespread and rising homeownership as a given, the severe depth and duration of the current and continuing recession in home sales raises a profound concern that we believe needs to be identified and addressed. It is worthy of our most responsible and courageous political actions, in the highest meaning of that maligned word "political."

The cumulative losses of home sales in the current recession are greater than in any previous recession. The data are shown in Table 2.

TABLE 2

SEVERITY OF DECLINE IN EXISTING HOME SALES DURING TIGHT MONEY PERIODS

Tight Money Periods	Duration of Sales Cycle (Peak to Recovery)	Percent Decline in Existing Home Sales (Peak to Trough)	Unit Volume of Sales Lost	Dollar Volume of Sales Lost (In Billions of Dollars)
1969-1970	21 months	-19.9 percent	236,000	$ 5.7
1973-1975	32 months	-18.4 percent	489,000	$ 17.4
1979-1981	34 months (so far)	-43.8 percent	2,494,000	$175.6

Source: NATIONAL ASSOCIATION OF REALTORS®

The American view is clear that widespread homeownership ensures democracy. This comes about by the fact that homeownership disperses decision-making to each individual household over the use and protection of the individual home. Each individual homeowner quite naturally has a stronger incentive to assure success and good conditions in the neighborhood, the community, town or city. Thus the fact that two-thirds of the nation's occupied housing units are owner-occupied is a basic reason that democracy is more of a fact in the United States than elsewhere in the World. This view is not new and is the foundation on which national housing policies since the 1930's have been erected. This view was again documented in the recent national survey conducted during August, 1981, by the Cambridge Surveys, Inc. and commissioned by the NATIONAL ASSOCIATION OF REALTORS®. In that survey, 71 percent of all respondents agree with the statement that widespread homeownership ensures greater democracy. Widespread agreement cuts across all regions, all age groups, and all income levels. These data, which confirm the importance in our national set of values of homeownership, underscore the profound importance of the current, prolonged, and continuing recession in housing. They are shown in Table 3.

TABLE 3

ATTITUDES OF PUBLIC ON WHETHER OR NOT WIDESPREAD HOMEOWNERSHIP INSURES GREATER DEMOCRACY

(Percentage Distribution)

	Agree	Neither Agree Nor Disagree	Disagree	Don't Know
Total United States	71	8	12	10
Less than $10,000 Income	61	9	12	18
$10,000 to $19,999	67	8	16	10
$20,000 to $34,999	76	7	10	8
$35,000 and over	81	8	8	3
25 years of age and under	65	11	17	10
26 to 45	75	11	13	10
46 to 65	76	5	10	9
over 65	73	5	9	13
Northeast	72	10	9	9
Industrial	63	8	15	13
Midlands	72	10	10	8
South	75	5	10	10
Central	73	13	11	4
Pacific	73	4	9	13

Source: Cambridge Reports, Inc. for NATIONAL ASSOCIATION OF REALTORS®

The basic cause of these severe conditions is the excessive reliance on monetary policy, rather than relying on monetary policy used in conjunction with an equally restrictive fiscal policy. We agree that an effective anti-inflation program requires a long-term policy reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices.

However, a less restrictive monetary stance and a tighter and better directed fiscal policy with reducing deficits would more evenly and fairly place the burden of fighting inflation, would be more effective in lowering inflation and interest rates, would better encourage investment in housing and industry, would prevent a renewal of long run inflation in the future from capital and housing shortages, and would lead to stronger growth overall.

The consequences of increases in the deficit are basically that they would be financed by reductions in private credit of which, by experience, about one-fourth is for housing. Thus, for each $10 billion of any such deficit increase, we could expect that the private borrowing crowded out would include $2.5 billion for housing, which would mean about 100,000 fewer families could improve their housing.

Because of this crowding out relationship, we are most concerned about the decisions on and estimates of the 1982 deficit. This concern is more severe because of the record in recent years of budget busting in budget outlays from the January-March date when the President presents a budget, until about 21 months later when the actual spending is known (see Table 4). We would plead for reform in this record. While we believe that sufficient spending reductions can and should be made, we realistically recognize such action is not assured, and further that unanticipated spending increases tend to exceed budgeted amounts (see Table 4).

TABLE 4

OVERRUN IN ACTUAL SPENDING CONTRASTED TO PRESIDENT'S ORIGINAL BUDGET ESTIMATES AND OUTLOOK FOR 1982 SPENDING OVERRUNS

(Dollars in Billions)

	January Budget Estimates*	Actual Spending	Spending Overrun	
			Percentage	Amount
1972	$229.2	$232.0	1.2	$ 2.8
1973	246.3	274.1	11.3	27.8
1974	268.7	269.6	0.3	0.9
1975	304.4	326.2	7.1	21.8
1976	349.4	366.4	4.9	17.0
1977	394.2	402.7	2.2	8.5
1978	440.0	450.8	2.4	10.8
1979	500.2	493.6	-1.1	-6.6
1980	531.6	579.6	9.0	48.0
1981	615.8	661.2**	7.4**	45.4
1982	695.3 (March 10)	Estimates: 1st Budget Resolution 695.5	0.0	0.2
		Mid-session Review 704.8	1.4	9.5
		Congressional Budget Office Sept.81 718-723	3.3-4.0	22.7-27.7
72-82 Average			4.4	17.0

* Estimated in President's Budget nine months before start of fiscal year

** OMB Estimate, July 15, 1981

Source: Office of Management and Budget (OMB)

For the above reasons we have proposed that if the President and the Congress believe the necessary spending cuts are impossible, they must -- to reduce the deficit to bring down interest rates -- defer the 10 percent across-the-board reduction in individual income tax rates from July 1, 1982, to October 1, 1982, and do the same in 1983. We believe that either the needed spending reductions or the tax relief delay is critically needed. We believe that delay of dates for tax relief is an appropriate kind of action to be taken as part of the Second Budget Resolution as part of the actions needed in light of all of the spending and revenue actions that have been taken since the First Budget Resolution and the Omnibus Budget Reconciliation Act.

ATTACHMENT 1

POTENTIAL IMPACT OF ALL SAVERS CERTIFICATES ON HOUSING, EXISTING HOME SALES AND MORTGAGES

States	Housing Starts	Existing Home Sales	Additional Mortgage Funds (Millions)
UNITED STATES	250,000	437,500	$30,000
Alabama	4,700	8,225	564
Alaska	550	962	66
Arizona	6,825	11,944	819
Arkansas	2,875	5,031	345
California	28,950	50,663	3,474
Colorodo	5,075	8,881	609
Connecticut	1,900	3,325	228
Delaware	525	919	63
District of Columbia	450	788	54
Florida	27,900	48,825	3,348
Georgia	8,800	15,400	1,056
Hawaii	1,500	2,625	180
Idaho	1,125	1,969	135
Illinois	6,050	10,587	726
Indiana	4,450	7,788	534
Iowa	2,000	3,500	240
Kansas	2,575	4,506	309
Kentucky	3,375	5,906	405
Louisiana	4,850	8,488	582
Maine	1,025	1,794	123
Maryland	4,125	7,219	495
Massachusetts	3,075	5,381	369
Michigan	6,050	10,588	726
Minnesota	4,850	8,488	582
Mississippi	2,975	5,206	357
Missouri	4,650	8,138	558
Montana	425	744	51
Nebraska	1,825	3,194	219
Nevada	2,175	3,806	261
New Hampshire	1,250	2,188	150
New Jersey	3,775	6,606	453
New Mexico	1,725	3,019	207
New York	5,100	8,925	612
North Carolina	7,975	13,956	957
North Dakota	825	1,444	99
Ohio	6,700	11,725	804
Oklahoma	4,900	8,575	588
Oregon	4,225	7,394	507
Pennsylvania	6,300	11,025	756
Rhode Island	625	1,094	75
South Carolina	4,575	8,006	549
South Dakota	975	1,706	117
Tennessee	5,275	9,231	633
Texas	26,125	45,719	3,135
Utah	2,100	3,675	252
Vermont	600	1,050	72
Virginia	7,100	12,425	852
Washington	7,050	12,338	846
West Virginia	1,200	2,100	144
Wisconsin	5,075	8,881	609
Wyoming	850	1,488	102

ATTACHMENT 2

U.S. ECONOMIC OUTLOOK
(September 1981)

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	81:1	81:2	81:3	81:4	82:1	82:2	82:3	82:4	1979	1980	1981	1982	1983
AGGREGATE ECONOMY													
Gross National Product ($ billions)	2,853	2,882	2,939	3,021	3,107	3,204	3,310	3,420	2,414	2,626	2,924	3,260	3,672
Percent Change	19.2	4.1	8.2	11.7	11.9	13.1	13.9	14.0	12.0	8.8	11.3	11.5	12.6
Percent Change (without inflation)	8.6	-2.4	0.1	2.3	3.6	4.5	5.1	4.5	3.2	-0.2	2.1	3.0	4.0
Consumption	5.8	-2.0	4.3	3.4	3.1	4.0	4.9	4.1	2.9	0.5	3.0	3.4	3.7
Residential Investment	3.2	-20.9	-16.1	-13.0	23.9	35.4	13.9	11.3	-5.2	-18.6	-1.6	7.3	16.4
Nonresidential Investment	13.4	-3.9	2.5	3.5	7.0	10.0	11.7	8.1	6.5	-3.0	2.0	6.3	7.7
Structures	16.6	5.1	-1.5	0.5	2.7	2.7	8.0	5.9	8.7	-0.1	3.3	2.7	4.9
Equipment	11.8	-7.8	4.4	4.9	8.9	13.3	13.3	9.1	5.5	-4.2	1.5	7.8	8.9
Exports	13.6	-6.9	-1.7	-1.9	-0.2	2.3	4.9	6.2	15.2	9.6	-0.8	0.3	6.0
Imports	10.3	12.8	3.4	4.0	5.8	6.5	8.2	8.1	6.0	-0.1	5.3	6.2	6.5
Government Purchases	5.3	-5.7	-0.6	0.9	1.3	0.9	1.3	0.1	1.5	2.9	0.1	0.4	0.3
Consumption (% of GNP)	63.3	63.4	64.0	64.2	64.1	64.0	64.0	63.9	62.8	63.2	63.7	64.0	63.9
Residential Investment (% of GNP)	3.4	3.2	3.1	2.9	3.1	3.3	3.3	3.4	4.0	3.2	3.1	3.3	3.7
Nonresidential Investment (% of GNP)	10.7	10.6	10.7	10.7	10.8	11.0	11.1	11.2	11.0	10.7	10.7	11.0	11.4
Inventory Change ($ billions)	4.5	21.2	7.1	12.1	15.9	16.3	18.2	23.9	17.5	-5.9	11.2	18.6	21.9
Mfg. Capacity Utilization Rate (%)	80	80	80	80	81	82	83	84	86	79	80	82	84
Manufacturing Industrial Production (% change)	7.1	3.5	2.1	5.2	7.6	8.4	9.2	6.7	4.6	-4.5	4.4	6.5	6.2
Employment (millions)	98.0	98.9	99.2	99.5	100.1	100.8	101.6	102.3	96.9	97.3	98.9	101.2	103.7
Unemployment Rate (%)	7.3	7.4	7.2	7.5	7.4	7.2	7.0	6.9	5.8	7.1	7.3	7.1	6.8
Disposable Income per Household (average)	25,251	25,690	26,370	27,135	27,743	28,394	29,623	30,401	21,565	23,748	26,112	29,040	32,432
Percent Change -- Year Ago (w/o inflation)	0.3	1.8	1.8	2.4	2.2	2.7	4.3	3.9	2.2	-0.1	1.6	3.3	3.7
Total Taxes per Household (average)	13,341	13,362	13,456	13,587	13,991	14,384	14,369	14,774	11,106	12,057	13,437	14,379	15,377
Percent Change -- Year Ago	13.3	14.4	11.4	7.1	4.9	7.6	6.8	8.7	10.5	8.6	11.4	7.0	6.9
Household Debt as Percent of Disposable Income	77.9	77.7	76.7	75.6	75.1	74.6	72.9	72.4	80.2	79.3	77.0	73.8	71.4
Consumer Price Inflation (CPI)	10.8	7.5	9.4	8.7	8.2	8.6	8.3	8.2	11.3	13.5	10.0	8.5	8.2
Gross National Product Inflation (GNP Deflator)	9.8	6.6	8.1	9.1	8.0	8.2	8.3	9.1	8.5	9.0	9.0	8.3	8.3
Personal Consumption Inflation	8.0	7.0	7.7	7.6	7.6	7.6	7.9	8.0	8.9	10.2	8.2	7.6	7.8
Residential Construction Inflation	10.1	4.7	8.2	9.1	10.7	10.3	10.6	10.6	12.8	9.4	7.0	9.6	10.7
Nonresidential Construction Inflation	5.1	14.1	8.9	10.3	11.5	10.8	11.2	11.2	12.6	13.4	9.5	10.9	11.3
Producers Price Inflation (WPI)	10.0	7.0	6.9	9.1	8.6	8.9	10.3	10.6	12.5	14.1	9.7	8.8	10.3
Compensation per Manhour (% change)	11.4	9.8	9.4	9.4	10.1	9.6	9.4	9.3	9.7	9.9	10.1	9.6	9.4
Productivity (% change)	4.1	-0.8	-0.2	1.2	1.4	1.3	1.6	2.1	-0.7	-0.3	1.1	1.1	1.9
Unit Labor Cost (% change)	6.9	10.8	9.5	8.1	8.6	8.2	7.6	7.1	10.4	10.3	8.9	8.5	7.3
Unit Capital Cost (% change)	10.7	10.2	9.7	9.1	8.8	8.6	8.6	8.8	11.1	11.0	9.9	8.7	9.4
Before Tax Corporate Profits ($ billions)	286	256	246	258	272	287	304	322	255	258	262	296	347
Corporate Tax Liability	88	75	72	76	80	85	91	97	88	82	77	88	108
'Windfall Profits' Tax Receipts	29	31	27	28	28	29	29	30	0	13	29	29	31
Inventory Valuation Adjustment	-39	-23	-28	-33	-36	-38	-43	-47	-43	-46	-31	-41	-51
Capital Consumption Adjustment	-15	-15	-5	-7	-11	-13	-15	-17	-16	-17	-11	-14	-14
After Tax Profits	169	150	147	155	164	173	184	195	168	163	155	179	212
Profits from Current Production (with IVA, CCA)	115	112	114	115	116	121	126	131	109	100	114	123	147
Adjusted for Inflation (81;1 base)	115	110	110	109	107	110	112	114	126	107	111	111	122
Percent Change - Year Ago	-1.1	5.2	5.3	8.1	-6.8	-0.3	1.7	5.2	-1.6	-15.7	4.2	-0.1	9.9
Per Unit of Output (% of GNP)	4.0	3.9	3.9	3.8	3.7	3.8	3.8	3.8	4.5	3.8	3.9	3.8	4.0
Effective Corporate Tax Rate (%)<1>	43	41	39	40	41	42	42	43	45	45	41	42	42
Federal Tax Receipts (Unified basis)	541	735	617	558	573	835	664	626	481	533	613	675	730
Federal Expenditures (Unified basis)	669	670	668	705	720	722	740	771	509	601	677	740	800
Surplus or Deficit (Unified basis)	-128	65	-51	-147	-148	113	-76	-145	-28	-68	-64	-65	-70

<1> Adjusted to include impact of windfall profits tax on domestic crude oil production.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulation, by Dr. Jack Carlson, Hugh Graham, Kenneth Kerin, and Glenn Crellin.

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ATTACHMENT 3

REAL ESTATE AND FINANCIAL MARKETS
(September 1981)

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	81:1	81:2	81:3	81:4	82:1	82:2	82:3	82:4	1979	1980	1981	1982	1983
REAL ESTATE MARKETS													
Existing Single-Family Home Sales (thousands)	2,543	2,600	2,507	2,703	2,965	3,078	3,163	3,288	3,701	2,881	2,588	3,124	3,731
Percent Change - Year Ago	-15.4	5.5	-18.0	-9.8	16.6	18.4	26.2	21.6	-4.2	-22.2	-10.2	20.7	19.4
Dollar Volume (billions)	193.3	204.7	202.7	219.1	243.5	261.6	276.5	290.1	237.6	209.7	205.0	267.9	348.9
New Single-Family Home Sales (thousands)	510	453	422	485	504	514	524	563	709	531	467	526	661
Percent Change - Year Ago	-4.1	0.1	-29.8	-10.3	-1.1	13.6	24.1	16.0	-13.2	-25.1	-12.0	12.6	25.6
Private Housing Starts (thousands)	1,391	1,170	1,046	1,138	1,322	1,424	1,515	1,583	1,745	1,292	1,186	1,461	1,760
Single-Family	874	780	684	740	872	953	1,005	1,042	1,194	852	770	968	1,205
Multi-Family	517	390	362	397	451	470	511	541	551	440	417	493	555
Subsidized	136	156	155	157	161	163	165	161	120	156	151	163	153
Mobile Home Shipments (thousands)	248	255	205	201	220	232	240	241	276	224	227	233	244
Housing Inventory (millions)	84.2	84.4	84.5	84.7	84.8	85.0	85.2	85.5	82.8	83.7	84.5	85.1	86.1
New Construction Put In Place - (Value)													
New Commercial Buildings (% Change)	54.1	-11.6	-6.8	10.5	13.2	17.5	11.2	14.9	33.8	21.7	7.8	9.0	13.0
New Industrial Buildings (% Change)	78.4	8.7	2.8	6.3	-23.9	25.4	27.1	30.2	37.2	-6.7	12.4	17.9	29.1
Rental Vacancy Rate (%)	5.2	5.0	5.1	5.0	5.0	5.0	4.8	4.9	5.4	5.4	5.1	4.9	5.0
Unsold New Homes (% of sales)	65.8	72.8	63.2	60.8	58.1	59.5	61.0	62.0	59.3	70.2	65.6	60.1	62.5
Office Vacancy Rate (%)<1>	3.9	4.2	4.2	4.1	4.0	3.9	3.8	3.8	4.4	3.7	4.1	3.9	3.4
Industrial Vacancy Rate (%)<1>	3.8	3.6	3.7	3.8	3.7	3.6	3.6	3.5	3.0	3.5	3.7	3.6	3.4
Existing Home Prices - Median ($1000's)	64.3	66.4	68.9	69.5	70.8	73.6	76.0	76.9	55.7	62.2	67.3	74.4	81.7
Percent Change - Year Ago	9.4	7.7	7.0	9.8	10.1	10.8	10.3	10.6	14.1	11.7	8.5	10.5	9.9
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	667	721	781	745	693	697	743	761	433	588	729	724	811
Percent of Household Income	27	28	30	28	25	25	26	26	20	25	28	25	26
New Home Prices - Median ($1000's)	67.2	70.2	70.7	71.7	73.3	75.0	76.8	78.7	62.7	64.9	70.0	75.9	83.7
Percent Change - Year Ago	5.6	10.7	7.5	7.7	9.0	6.9	8.6	9.8	12.5	3.4	7.9	8.6	10.2
New Home Prices--Mean ($1000's, Quality Adjusted)	83.3	85.1	87.4	87.6	91.1	93.8	95.7	96.0	71.4	78.5	85.8	94.2	102.4
Percent Change - Year Ago	10.3	8.5	9.3	9.1	9.4	10.2	9.5	9.6	14.8	10.1	9.3	9.7	8.8
FINANCIAL MARKETS													
Total Time and Savings Deposits (% change)	13.1	3.1	4.9	7.3	8.8	8.6	8.0	8.2	8.6	7.5	8.5	7.5	8.1
Savings Rate (%)	4.6	5.3	5.2	5.6	5.5	5.2	6.5	6.5	5.3	5.6	5.2	5.9	6.7
Money Supply (M1B) (% change)	4.9	9.3	1.9	6.8	3.7	3.5	8.1	5.4	7.8	6.3	7.3	5.0	5.8
Money Supply (M2) (% change)	8.5	12.2	7.2	6.8	6.0	6.9	9.5	10.5	8.9	8.9	9.6	7.5	11.7
New Mortgage Commitments ($ billions)	72.7	62.2	51.4	64.8	71.9	81.0	85.4	86.0	129.0	88.0	62.8	81.1	91.7
Percent Change - Year Ago	-10.4	33.1	-57.6	-36.8	-1.2	30.3	66.0	32.7	-9.2	-31.8	-28.6	29.1	13.0
Mortgage Debt Outstanding ($ billions)	1,475	1,497	1,524	1,551	1,580	1,604	1,629	1,655	1,266	1,401	1,512	1,617	1,745
Homeowners' Equity ($ billions)	2,835	2,922	2,983	3,043	3,118	3,178	3,257	3,352	2,618	2,759	2,946	3,226	3,617
Selected Interest Rates (Percent)													
New Home Mortgage Commitment Rate	15.40	16.16	16.90	15.92	14.48	13.98	14.46	14.66	11.27	14.00	16.09	14.40	14.70
Corporate Bond Rate (AAA)	13.16	13.98	14.62	14.43	14.06	14.09	14.34	14.19	9.63	11.94	14.05	14.17	13.39
Rate on Money Market Fund Shares	15.67	16.51	18.42	17.07	17.66	18.40	19.08	18.00	11.12	12.89	16.92	18.29	16.02
Commercial Paper Rate	15.34	16.15	17.97	16.71	17.24	17.95	18.72	17.69	10.97	12.66	16.54	17.90	15.11
Prime Rate	19.21	18.93	20.54	18.76	19.19	19.84	20.37	19.68	12.67	15.27	19.36	19.77	16.06
Federal Funds Rate	16.57	17.78	19.05	17.95	18.27	18.93	19.46	18.32	11.19	13.36	17.84	18.74	14.45

<1> Historical data courtesy of Coldwell Banker.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Hugh Graham, Kenneth Kerin, and Glenn Crellin.

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REALTOR®

SUBMITTED STATEMENT OF

PETER C. TRENT

CHAIRMAN OF THE

PUBLIC SECURITIES ASSOCIATION

BEFORE

THE BUDGET COMMITTEE

OF THE U.S. SENATE

AT HEARINGS

TO CONSIDER THE EFFECTS OF THE PRESIDENT'S

ECONOMIC POLICY ON U.S. FINANCIAL MARKETS

September 28, 1981
Washington, D.C.

The Public Securities Association represents dealers and dealer banks active in the public fixed income markets. We currently have nearly 300 regular members, whose offices are located in all 50 states. Last year our members participated in over 95% of the dollar volume of new issues of state and local bonds, and they also comprise the vast majority of firms active in the secondary market. Our membership participates in the full range of dealer activities, including small firms dealing in special assessment issues and local financings, multimillion dollar investment banking powers, full service wire houses with offices spanning the nation, major money market center and regional dealer banks. Our membership also includes approximately 75 associate members (such as bond counsel, accounting firms, and clearing corporations), whose activities are closely related to the municipal bond market. Therefore, we feel particularly qualified to speak on behalf of this marketplace.

Basic Market Characteristics

The municipal bond market is one of the largest fixed income markets in the world. Current estimates indicate that there are $325 billion in state and local government bonds outstanding, and current volume of long-term new issues probably exceeds $50 billion annually.

Local governments have three principal sources of money to provide the means of supplying governmental service to our society; these are tax revenues, transfer payments from other levels of government, and the sale of fixed income securities. The current trend towards taxpayer revolts and a changing perception of the role of the Federal government as a supplier of financial support threaten to curtail two of these major sources of revenue. For this reason, the continued health and efficiency of the municipal bond market is of critical importance to the continued ability of states and localities to meet the needs of their citizens and in turn to the continued health and efficiency of our Federal system of government.

The municipal market has several basic characteristics which set it apart from other fixed income markets. First and foremost, the interest paid on state and municipal bonds is exempt from Federal income taxes. This Constitutionally affirmed principle enables local governments to borrow at rates substantially below other taxable fixed income rates, and has provided a benefit to society of billions of dollars. In many states, state and local issues also benefit from exemption from various state taxes further reducing costs.

Second, the municipal market has provided municipal investors with unparalleled investment safety. The creditworthiness of municipal securities is an important component in their marketability. Their continued financial health is essential to allow them to provide for the needs of society.

Three, this market is characterized by a staggering variety of individual issues. Estimates vary, but there are approximately

50,000 political entities that have debt outstanding. The vast majority of issuers sell long term bonds in serial maturities, each one constituting a separate "issue." For this reason, the universe of outstanding municipal issues approaches 1-1/2 million. This precludes maintaining continuous two-sided markets in most municipal issues. Because of the infrequency of activity in any given specific issue, there is little opportunity to utilize some of the fundamental techniques of other securities markets, such as a centralized exchange, an effective "auction" market, and the ability to sell "short." Despite this, there is a very active, sophisticated and competitive secondary market for most municipal issues.

Investor Demand for Municipals*

Since the mid-1950's three categories of investors have dominated the municipal securities market. Of the $325 billion of municipal debt outstanding at the end of 1980, we estimate that commercial banks held approximately 46.4 percent, or $151 billion. Households held $63 billion, or 19.3 percent, and property and casualty insurance companies held $90.2 billion, or 27.7 percent.

The relative importance of each of the three major investors has shifted over the years. Through much of the 1960's, commercial banks absorbed two-thirds of all new municipal issues. In the 1970's, they took on less than one-third. Casualty insurance companies took up much of the slack with some help from the household sector. Tax bracket creep and the development of open-end bond funds and unit investment trusts have increased the participation of individuals in the market.

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* Statistical information concerning investor demand for municipal securities was provided to PSA by Dr. Ronald Forbes, Director, Municipal Finance Study Group, School of Business, State University of New York at Albany.

Commercial Bank Demand

Commercial bank demand for municipals increased steadily throughout the 1960's, peaking in 1971 with a $12.6 billion net increase in bank holdings of tax-exempt securities, accounting for 72 percent of the market in that year. Generally, bank demand for municipals since 1971 has diminished. Current statistics show that municipal securities are a relatively minor portion of the assets of commercial banks--10 percent as opposed to 22 percent in 1971. Table 7 shows bank demand for municipals since 1971.

One of the reasons for a slackening in bank demand is that commercial bank profitability has not been strong in recent years. In addition, leasing operations, through which commercial banks make use of investment tax credits have become increasingly popular as a means of sheltering income from taxes. This practice is likely to expand as a result of accelerated depreciation changes in the 1981 tax law.

Another market force may affect bank investment patterns in municipals. Traditionally, commercial banks have shown a marked preference for short and intermediate term municipal securities. A survey by the American Bankers Association shows that in 1980, 42 percent of all bank holdings of municipal securities were of maturities of five years or less. Thirty-one percent of bank holdings were in the 6-10 year maturity category and only 27 percent of bank municipal portfolios had maturities of more than 10 years. (See Table 8).

Another recent survey of bank portfolio managers suggests that commercial banks are increasing their preference for short-term municipals. Planned purchases of municipal securities by banks in 1981 was 67 percent concentrated in the less than 5-year range and 25 percent concentrated in the traditional "bank maturity range" of 6-10 years. This is largely due to the increased sensitivity of bank liabilities to short-term interest rates. Thus, banks are endeavoring to match their interest rate sensitive assets with their rate sensitive liabilities. This practice, known as Asset-Liability or "Spread" management is likely to prevail as Regulation Q ceilings are phased out and the use of variable rate commercial and real estate loans grow.

Property and Casualty Company Demand

Property and casualty insurance companies have been important participants in the long-term municipal revenue bond market. The basic motivation for property and casualty company demand for municipals is the same as for commercial banks--

profitability. Their demand for municipal securities is directly related to underwriting profits (or losses). Insurance company profits are cyclical; therefore their purchases of municipal securities follow these cycles.

Property and casualty company participation in the municipal market peaked in 1978-79 (see Table 9). As Table 10 shows, property and casualty companies have experienced severe and steadily rising underwriting losses since 1979. Since these institutions are expected to have record losses in 1982, it is unlikely that they will be major buyers of municipals in the near future.

Another factor influencing property and casualty company purchases of municipal securities has been their disaffection for common stocks. Their holdings of common stocks declined from 34 percent of assets in 1965 to 14 percent in 1977. Conversely, their holdings of municipal securities increased from 24 percent of assets in 1965 to 42 percent in 1977. A sustained rally in the equities market could lead to a reallocation of assets by property and casualty companies to common stocks as underwriting profits return.

Individual Investor Demand

The individual has traditionally been regarded as the "residual" element in the demand equation for municipal securities. Their activity in the market fluctuates widely, with the greatest volume of purchases normally when municipal rates are near their highest levels. In 1969, to take one extreme example, interest rates were at their cyclical peak and individuals accounted for the purchase of almost 97 percent of net new municipal issues. In 1974 and 1975, municipal rates rose to unusually high levels compared to corporate rates (see Table 2), and individuals were again attracted to the market by high interest rates to absorb more municipal bonds than any other single group of investors.

With reduced demand for municipals by commercial banks and property and casualty companies, individuals have been an important element of the municipal market during 1981. Table 11 shows participation in the municipal market by individuals from 1971 through the first quarter of 1981. At present, individuals are purchasing approximately seventy-five percent of the new long-term financings of state and local governments. For the short-term market the figure is about fifty percent.

Although total holdings of municipal securites by the household sector has not increased significantly in recent years, a larger number of individuals probably have participated in the market through unit investment trusts and open-end funds purchasing municipal securities. At the end of 1980, unit trusts held $23 billion of municipal securities and open-end funds accounted for $4.8 billion.

Recent Innovations in Municipal Finance

State and local governments have become more innovative in their financing strategies. Traditionally, municipal bond issues consisted of serial maturities and term bonds due in 30-40 years. Short-term notes, generally one year or less in maturity, have traditionally been issued to bridge the gap in anticipation of income tax revenues on new issues of bonds.

Investor concern over future inflation and significant demand for shorter maturities have been the impetus for several new developments in municipal finance.

A number of municipal issuers have issued "put-option" bonds. Also known as "option-tender" bonds, they allow an investor to redeem bonds at par value on specified dates many years before stated maturity. This feature is designed to provide investors with a hedge against future interest rate increases.

Another innovation is the use of letters of credit, usually issued by a major bank. These letters of credit provide additional assurance that funds will be available to retire bonds at maturity, or in the case of "put" bonds, on the option dates.

Variable note securities, keyed to current interest rates, have also been sold by municipal issuers. Interest rates are adjusted periodically usually in relation to the rates on government bonds. This is designed to provide protection to investors in a rising rate environment and reduced interest costs to borrowers if rates decline.

Municipal lease obligations are designed to provide money for various capital investments, often of short useful life. They generally provide for rapid repayment of principal and interest, and have been used at times to avoid some of the problems of debt issuance, such as voter approval.

To date, about 16 state and local governmental units have issued tax-exempt commercial paper. This concept, which was originally developed for municipal revenue bond issuers, has now been used by at least one city (Columbus, Ohio), one county (San Diego, California) and, just last week, the State of Connecticut, which issued $115 million in commercial paper at interest rates ranging from 8 percent to 8-1/2 percent. To date, about $1 billion of municipal commercial paper has been issued.

Concerns over the ability to meet debt service obligations has spurred the use of new issue insurance. Several billion dollars in par value of issues has been insured as to principal and interest by two companies that specialize in this area.

The Current Municipal Market

1980 was a record year for new issues of municipal securities. A total of $76 billion of securities were issued. New issues of long-term debt exceeded $50 billion and short-term debt amounted to nearly $28 billion. Even with the record volume of new issues and credit market volatility experienced in 1980, the tax-exempt market provided state and local governments with interest cost savings of 35 percent for long-term issues and 58 percent for short-term issues, as compared to taxable securities of equivalent risk and maturity. It is estimated that in 1980 for the long-term market alone, the tax-exempt feature saved states and local governments about $2.5 billion.

The municipal market has grown considerably since 1970.

In that year, long-term and short-term borrowing together totalled only $36 billion. The volume of new issues of municipal securities for the period 1970-1981 and the cost savings resulting from the tax exemption for this period are shown in Tables 1 and 2 in the Appendix.

New issue volume has been off somewhat during the first eight months of 1981. During this period, $29.2 billion of long-term debt and $22.7 billion of short-term debt was issued, amounting to $51.9 billion. Tables 3 and 4 show 1981 volume by month, along with monthly comparisons of tax-exempt and taxable yields for both long and short-term issues.

Table 5 shows the steady increase since June 1980 in the Bond Buyer Index for municipal general obligation bonds and the Bond Buyer Index for revenue bonds. The Bond Buyer G.O. bond index peaked at an all-time record high of 13.21 percent on September 10, 1981, as did the revenue bond index at 14.24 percent. In the last two weeks, municipal rates have come down somewhat. On September 25, the G.O. bond index was at 12.57 percent and the revenue bond index was 13.62 percent.

The Effect of High Interest Rates

Yet, while the borrowing costs of states and local governments have increased substantially, their costs have not increased relative to those of other borrowers. Our figures show that the traditional relationship between tax-exempt and taxable rates of interest remains basically the same. (See Appendix, Table 4). For example, the relationship between short-term tax-exempt interest rates and short-term taxable rates has remained at its basic level of approximately 44%. The relationship between long-term tax-exempt and taxable interest rates while higher than normal, for the most part has remained within historic bounds of approximately 70% - 75%.

This relationship probably underestimates the true spread. If taxable borrowers such as corporations and the Federal government were placing similar demands on the long-term market the interest rates they would have to pay would be substantially higher than is currently indicated.

Although the historical relationship between taxable and tax-exempt rates has persisted, the increase in cost, although less percentage wise, is borne in full by state and local governments. Private borrowers can deduct interest costs, making the Federal government a partner in any increase. Public borrowers do not have this luxury. For example, a corporation in a 46% tax bracket only pays 54¢ for each additional $1 in interest cost. If the historical spread between taxable and tax-exempt bonds remains at 70% then a long-term municipal issuer would pay 70¢ in additional interest for each $1 that taxable rates increased. But the municipality must pay the full 70¢. Even though its rate of interest does not increase as much as a taxable borrower, its actual costs increase more.

The high interest rates experienced by the municipal securities market are a result of a number of factors, the most important of which are: inflation; vast demand for capital both by the private sector and the Federal government; and a monetary policy intended to alleviate the effect of the preceding two factors.

The cost of higher interest rates to state and localities is substantial. By way of example, each additional one percent will cost state and local governments an additional $500 million annually on an estimated volume of $50 billion in long-term financing. If one assumes an average life of the securities of 15 years, this would be a cost of $7.5 billion.

During the 1970's the Bond Buyer Index (BBI) averaged 6.95%. So far this year, the BBI has averaged 9.88%. This differential of 293 basis points means an added interest cost of $1.5 billion per year or $22.5 billion over the estimated life of the debt, based on current estimates of new long-term financing.

Recent inflation has caused the value of outstanding municipal bonds to decrease substantially. Dealers and investors have realized billions of dollars in paper losses and confidence in the long-term fixed income markets has been seriously impaired.

We believe that the primary factor affecting the municipal market is inflation and the fear of investors that the Federal government will not persevere in the fight against it. Persistent inflation has plagued all participants in the fixed-income securities markets.

In March 1981, the PSA Board of Directors adopted the following resolution:

Recent inflationary pressures have forced the markets for fixed-income securities to experience historically high interest rates and unacceptable volatility which have increased significantly the borrowing costs of state and local governments and the U.S. Government and its agencies. The health of these markets is vital to the continued efficient operation of government at all levels of our society.

We support Federal efforts to implement a comprehensive economic plan that would reduce the rate of inflation and control Federal spending. We believe that the major components of any such economic plan would consist of a Federal budget which will restore the public's confidence in the Government's ability to control the growth of Federal spending; the adoption of a tax policy which would stimulate savings and investment; the elimination of excessive and unnecessary Federal regulation; and implementation of a Federal program that would reduce the Treasury's use of the public credit markets and establish a disciplined monetary policy. We believe this type of program will serve to improve investor confidence and the efficiency of the public credit markets.

Today we reaffirm that resolution and urge that Congress reduce Federal spending further and with it the inflationary fears of investors.

The Effect of Other Factors

In addition to inflation PSA is deeply concerned with certain other factors which have had an adverse effect on the market.

(1) The enactment of legislation authorizing issuance by depository institutions of the so-called "All-Savers" certificate has created an investment security which competes directly with state and local issuers. During consideration of the 1981 tax bill, PSA and state and local government groups warned Congress of the harmful effects of this credit allocation device on municipal borrowing costs. A study by the Municipal Finance Officers Association predicted that the "All-Savers" bill could cost state and local governments between $620 million and $1.1 billion annually in increased borrowing costs. However, those estimates may be too conservative. This study was based on estimates of certificate issuance that were substantially less than is now believed to be the case. Further, at the time of the study, it was believed that individual investors composed half of the municipal market. At this time, data of the Federal Reserve Board indicates that individual investors are purchasing over two thirds of all municipal securities issued. Thus, the certificate, which will be purchased exclusively by individual investors, will compete for the segment of the municipal market currently purchasing the majority of securities being issued.

(2) There is deep concern with a continuing tendency on

the part of the Federal government, particularly the Treasury and the IRS, to interfere with the municipal market through administrative actions and regulatory pronouncements, at times retroactive, which have been done without the benefit of hearings or legislative action. These rulings have at times had serious disruptive effects on the market, and we urge that such actions not be taken without full discussion and review.

In April 1979, a bill was introduced in the House of Representatives to restrict state and local government housing programs funded by mortgage revenue bonds. The bill was drafted to apply to mortgage bond financings initiated on or after the date of the legislation's introduction, April 25, 1979. Even though the legislation was not enacted until December 1980, the bill caused uncertainty and market congestion for more than a year and one-half while the legislation was pending.

In December 1980, the Internal Revenue Service issued Revenue Procedure 80-55, which would have disallowed all deductions for interest paid by financial institutions on time deposits made by state and local governments which were secured by pledges of tax-exempt bonds. The IRS ruling, which reversed a long-standing interpretation of the tax laws, was to apply retroactively. Its potential adverse effect was immediately apparent to participants in the municipal market. For example, at the time of the ruling, commercial banks held 43 percent of the $325 billion of outstanding municipal securities. This ruling was subsequently withdrawn, but only after concerted efforts by state and local governments and members of Congress.

(3) Municipal securities issuers must pay serious attention to the demands that they can place on the market and what priorities should be set for various types of financings. The recent Congressional Budget Office study on industrial revenue financing has generated some concerns which are shared by many PSA members. It is our belief that this subject should be approached within the broader context of overall credit demands and is best resolved at the state and local level.

(4) Concerns have been raised over the effects of the recent tax legislation on the demand for tax-exempt securities. Aside from the previously discussed effect of "All-Savers" we are not prepared to state unequivocably what the effects will be of the broader tax reductions. Although reduced marginal tax rates may have some negative effect this may well be offset by the additional income made available for investment, some of which will undoubtedly reach the municipal bond market.

(5) Capital is the lifeblood of a dealer operation. A large and healthy dealer community is vital to this market. Smaller, regionally oriented dealers have been particularly important to local issuers in many parts of the country. In reassessing capital rules, it is critical that these rules are not unduly restrictive. The secondary market, because of its nature, depends on the willingness and ability of the dealer community to position inventory, and this means allowing the broadest use of capital within the bounds of protecting investors and the public.

(6) In addition, the costs of maintaining inventories has increased with interest rates. Most dealers borrow to finance inventories. The interest they pay on such loans is not deductible. This has been a strong disincentive to maintain secondary market positions, which has in turn contributed to the volatility of this market. This volatility increases risk, and is a deterrent to developing investor interest. PSA recommends changing the tax law to allow legitimate registered dealers to deduct borrowing costs to finance trading positions. This should bring considerable liquidity and breadth back to the secondary market.

(7) Efforts are being made to improve the efficiency of bond clearance. The present antiquated form in which bonds are issued is cumbersome and costly. PSA has supported efforts toward immobilization, automated clearance, net settlement and other plans to modernize this area. Improving efficiency in this area will contribute to the attractiveness of municipal bonds as investments.

Conclusion

Although the municipal market has suffered in the recent past we will continue to work in partnership with state and local governments to enable them to provide for the needs of their citizens in the most efficient manner. We believe that the states and localities will meet these challenges now before them with continued resourcefulness, creativity, and responsibility. Congress can provide substantial support to state and local governments in this regard by approving policies to reduce Federal spending and in turn reduce inflation. Thank you.

APPENDIX

Table 1

STATE AND LOCAL BORROWING, 1970-1981
(All figures in Billions)

Year	Long-Term	Short-Term	Total	Number of Issues
(Jan-July) 1981	$23.1	$18.1	$41.2	3758
1980	48.4	27.7	76.1	7933
1979	43.3	21.7	65.0	7453
1978	48.3	21.4	69.7	8066
1977	46.7	24.8	71.5	8333
1976	35.3	20.1	55.4	6932
1975	29.3	29.0	58.3	8107
1974	22.8	29.0	51.8	7701
1973	23.0	24.7	47.7	8147
1972	22.9	25.2	48.1	8420
1971	24.4	26.3	50.7	8811
1970	17.8	17.9	35.7	7604

Source: Public Securities Association
Municipal Securities Data Base

Table 2

MUNICIPAL YIELDS AS A PERCENTAGE OF CORPORATE YIELDS

Year	Long-Term*	Short-Term**
(Jan-July) 1981	70%	43%
1980	65	43
1979	61	46
1978	63	46
1977	65	47
1976	70	49
1975	74	53
1974	68	50
1973	66	N/A
1972	69	N/A
1971	69	N/A
1970	75	N/A

Source: Moody's Bond Survey. Percentage calculations prepared by Public Securities Association

* Moody's yearly averages of yields on Aa municipal to Aa corporate bonds.

** Yearly averages of yields on tax-exempt 90-day project notes to 90-day commercial paper yields

Table 3

NEW ISSUES OF MUNICIPAL SECURITIES BY MONTH
(Amounts in billions)

Month	Long-Term	Short-Term	Total
January	$ 2.7	$ 2.4	$ 5.1
February	3.0	2.3	5.3
March	4.0	1.7	5.7
April	5.2	2.0	7.2
May	3.5	5.8	9.3
June	4.9	3.9	8.8
July	3.2	2.5	5.7
August	2.8	2.0	4.8
Jan-Aug 1981	$29.2	$22.7	$51.8
Jan-Aug 1980	$32.1	$19.9	$51.9
Dollar Change	($ 2.9)	$2.8	($ .1)
Percent Change	(9.1%)	14.0%	(.2%)

Source: Public Securities Association
Municipal Securities Data Base

TABLE 4 - TAX EXEMPT/TAXABLE YIELD RATIO

	SHORT TERM	LONG			
		Aaa	Aa	A	Baa
1978 Annual Average	44.2	63.1	63.4	65.5	66.0
1979 Jan.	45.5	64.3	63.4	65.8	70.5
Feb.	47.5	61.1	61.6	63.8	66.7
Mar.	47.4	62.1	62.2	62.5	62.5
April	48.5	61.8	61.2	61.3	60.5
May	45.4	61.2	60.8	62.4	60.9
June	43.9	59.6	60.2	61.2	59.6
July	42.9	60.7	61.7	61.0	59.4
Aug.	41.1	62.0	61.4	61.7	61.4
Sept.	42.6	59.7	63.4	62.2	61.4
Oct.	40.4	61.7	63.1	67.8	64.4
Nov.	43.8	60.3	59.9	60.7	63.9
Dec.	43.6	60.5	60.0	60.1	61.5
1979 Annual Average	44.4	61.3	61.6	62.5	62.7
1980 Jan.	38.5	59.3	58.1	59.3	61.2
Feb.	39.3	58.8	59.0	60.4	59.8
Mar.	39.4	63.0	62.0	64.8	71.3
April	42.3	66.0	62.3	62.0	64.8
May	55.8	61.9	58.2	60.1	60.9
June	42.9	67.2	64.2	64.3	62.8
July	42.2	66.4	66.3	66.9	66.9
August	42.0	69.0	69.1	69.5	70.3
September	47.7	68.9	69.2	69.5	68.2
October	39.4	68.1	67.9	69.7	66.1
November	40.0	67.2	66.7	68.5	66.5
December	39.2	71.5	69.9	69.9	70.3
1980 Annual Average	42.4	65.6	64.4	65.4	65.8
1981 January	40.2	70.1	68.0	68.7	65.9
February	38.9	70.9	70.1	69.2	66.0
March	43.4	71.3	70.5	69.7	67.8
April	44.3	70.5	70.8	71.1	69.7
May	40.0	69.0	69.5	70.2	70.5
June	43.0	71.7	71.5	71.4	70.9
July	44.9	71.0	71.9	71.9	71.4
August	46.2	74.5	77.7	78.6	78.2

SOURCES: Short Term: Federal Reserve Bulletin, Bank of America Quote Sheet, Weekly Money Market Summary of Continental Illinois National Bank and Trust Company

Long Term: Moody's Bond Survey

Table 5

THE BOND BUYER INDICES JUNE 1980-JUNE 1981

AVERAGE MUNICIPAL BOND YIELDS

Date	Twenty General Obligation Bonds	Twenty-Five Revenue Bonds
June 26, 1980	7.76%	8.52%
July 31, 1980	8.59	9.31
August 38, 1980	8.85	9.78
September 25, 1980	9.18	10.02
October 30, 1980	9.45	10.27
November 26, 1980	9.61	10.51
December 31, 1980	9.76	10.81
January 29, 1981	9.91	11.07
February 26, 1981	10.27	11.07
March 26, 1981	10.09	10.80
April 30, 1981	10.94	11.71
May 28, 1981	10.64	11.45
June 25, 1981	10.74	11.54

THE BOND BUYER INDICES BY WEEK JULY-SEPTEMBER 1981

AVERAGE MUNICIPAL BOND YIELDS

July 1, 1981	10.85%	11.66%
July 9, 1981	10.97	11.73
July 16, 1981	11.09	11.87
July 23, 1981	11.34	12.01
July 30, 1981	11.44	12.12
August 6, 1981	11.63	12.34
August 13, 1981	11.94	12.55
August 20, 1981	12.49	13.04
August 27, 1981	12.97	13.89
September 3, 1981	13.10	14.10
September 10, 1981	13.21	14.24
September 17, 1981	12.79	13.78

Table 6

MAJOR INVESTORS IN STATE AND LOCAL GOVERNMENT BONDS

Percentage Share of Bonds Outstanding for Selected Years, 1955-1980

Year	Percent Held by Households	Percent Held by Commercial Banks	Percent Held by Property and Casualty Insurance Companies
1955	42.2	28.2	9.1
1960	43.5	25.0	11.4
1965	36.3	38.7	11.3
1970	31.9	48.6	11.8
1975	30.4	46.0	14.9
1980	19.3	46.4	27.7

Source: Federal Reserve Flow of Funds Accounts

Table 7

SELECTED MEASURES OF COMMERCIAL BANK DEMAND

(Dollar Amounts in Billions)

Year	Net Change in Municipals	Changes in Commercial Bank Holdings Dollars	As % of Net Municipals	As % of Change in Bank Assets
1981(1Q)	30.7	13.0	42%	10%
1980	25.0	13.6	54	13
1979	18.9	9.5	50	7
1978	28.3	9.6	34	7
1977	23.7	9.2	39	9
1976	15.7	3.0	19	5
1975	16.1	1.8	11	6
1974	16.5	5.4	33	8
1973	14.7	5.7	39	7
1972	14.7	7.2	49	9
1971	17.4	12.6	72	22

Source: Board of Governors of the Federal Reserve System
Flow of Funds Accounts, First Quarter 1981

Table 8

COMMERCIAL BANK MUNICIPAL SECURITIES: MATURITY PREFERENCES, 1980

Maturity of Municipal Portfolios

Bank Size (Assets)	Less than 5 Years	6-10 Years	Over 10 Years
26-100 Mil.	49%	37%	14.7%
100-250 Mil.	41	32	27
250-500 Mil.	45	30	15
500-1 Bil.	46	26	28
1-10 Bil.	39	34	27
Over 10 Bil.	27	24	49
All Banks	42	31	27

Source: American Bankers' Association; 1981
Survey Commercial Bank Municipal Securities Portfolios

Table 9

PROPERTY AND CASUALTY INSURANCE COMPANY

PARTICIPATION IN THE MUNICIPAL MARKET

(Dollar Amounts in Billions)

		Changes in Casualty Company Holdings		
Year	Net Change in Municipals	Dollars	As % of Net Municipals	As % of Changes in Financial Assets
1981(1Q)	30.7	8.3	27%	42
1980	25.0	8.4	34	41
1979	18.9	12.3	65	61
1978	28.3	13.1	46	67
1977	23.7	10.7	45	53
1976	15.7	5.4	34	36
1975	16.1	2.6	16	36
1974	16.5	2.2	13	47
1973	14.7	3.6	24	56
1972	14.7	4.3	29	54
1971	17.4	3.5	20	53

Source: Board of Governors, Flow of Funds

Table 10

UNDERWRITING PROFIT (LOSS)

PROPERTY AND CASUALTY INSURANCE COMPANIES

(Stock)

Year	Underwriting Profit or Loss ($ Billion)
1982	(7.5) estimated
1981	(6.0) estimated
1980	(2.7)
1979	(1.0)
1978	N/A
1977	.8
1976	(1.4)
1975	(2.9)
1974	(1.7)
1973	.2
1972	.9
1971	.7

Source: 1971-77, Best's Aggregates and Averages
1979-82: Estimates by Value Line Investment Survey

Table 11

PARTICIPATION IN THE MUNICIPAL MARKET BY INDIVIDUALS
(Dollar Amounts in Billions)

Year	Net Change in Municipals	Dollars	Household Sector as % of Net Municipals	Purchases as % of Change In Financial Assets
1981(1Q)	30.7	7.8	25.4%	3.2%
1980	25.0	3.3	13.2	1.2
1979	18.9	(2.4)	(12.7)	(.9)
1978	28.3	3.3	11.7	1.3
1977	23.7	2.6	11.0	1.1
1976	15.7	2.5	15.9	1.3
1975	16.1	6.2	38.5	3.9
1974	16.5	8.3	50.3	6.3
1973	14.7	5.3	36.1	3.5
1972	14.7	2.3	15.6	1.8
1971	17.4	.1	.6	.01

Source: Federal Reserve Board of Governors, Flow of Funds

[From the Washington Post, Oct. 26, 1981]

STOCKS FALL, BONDS TUMBLE TO RECORD

(By James Peltz)

NEW YORK, September 25—The stock market fell to a 16-month low in active trading today amid concerns about President Reagan's ability to trim the budget and a noted analyst's reiteration that prices will slump further.

[And bond prices tumbled as much as 3 points before closing at record lows, with losses extending to 2⅜ points in fitful trading, Dow Jones News Service reported.]

Declines led advances by 10 to 1 on the New York Stock Exchange, with more tha [illegible],500 issues posting losses and fewer than 160 higher.

The Dow Jones average of 30 industrials fell 11.13 points to 824.01, bringing its loss for the week to 12.18 points. The measure had been down nearly 20 points earlier in the session.

The index has lost 200 points since it closed at an eight-year peak of 1,024.05 last April 27.

Big Board volume totaled 54.39 million shares compared with 48.88 million Thursday. Composite volume was 62.099 million shares.

The American Stock Exchange market value index dropped 15.36 points to 276.76, its lowest mark since June 3, 1980, when it closed at 273.69.

The NYSE's composite index was off 1.46 points to 64.96, Standard & Poor's index of 400 industrials fell 2.56 points to 125.93, and S&P's 500-stock composite index was off 2.24 points to 112.77.

[The bond markets continued to reel despite promises of further budget cuts from President Reagan and continued low financing costs reflected in federal funds trading at 14 percent to 14⅛ percent, Dow Jones said.

[While investors were selling fixed-income securities or shunning the market altogether, securities dealers were hedging against the prospective inventories of 20-year government bonds to be auctioned next Wednesday.

[The government 13⅞s of 2011, which traded between a new low of 91 and $^{24}/_{32}$ and 94 and $^{28}/_{32}$, closed between 92 and $^{12}/_{32}$ and and 92½ for a 15 percent yield and a loss on the day of 2⅜ points. Treasury bills declined 20 basis points in price.

[Corporate bonds plummeted before closing with losses of 2 points on average and talk that some new issues may come to market now, with coupons bearing a 20 percent yield. Municipal bonds fell 2 to 3 points in price.

[Government securities traders said the market broke this morning after interest rates futures in Chicago dropped to record lows, Dow Jones said.]

Oils were among the NYSE's most active losers, including Exxon ⅜ to 30, Mobil ⅜ to 25 and Occidental Petroleum 1½ to 23. Texaco lost ⅞ to 32½ despite announcing a successful well in the North Sea.

International Harvester rose 1⅜ to 10. The company said it agreed with its eight advisory banks on revised terms for its debt restructuring.

The NASDAQ composite index for the over-the-counter market fell 5.27 points to 175.12.

[From the Washington Post, Sept. 27, 1981]

WE ARE ON COURSE

(By Malcolm Baldrige]

In 200 days the Reagan administration has accomplished a historic and necessary change in the direction of long-term national economic policy. As a result, for the rest of the decade and beyond, government will govern less. It will spend less, tax less, borrow less and regulate less.

So much has been done, but so much remains to be done. We have come too far now to have our resolve shaken by recent skeptics who want instant gratification at the expense of sound, long-term goals.

It will take time for these changes to produce the tangible results our country desperately needs. The third and forth quarters of 1981 will not see them; real GNP will be relatively flat. The fourth-quarter results will probably show that we have virtually the same level of output as we did in the first quarter of 1980—two years with no progress. What's more, the economy has been jerked around like a yo-yo during that two-year period. Quarterly GNP variations have ranged from minus 10 percent, after imposition of credit controls, to plus 9 percent, after inflationary stimulation. On that kind of roller-coaster ride, individuals can't plan and follow through successfully. Neither can business nor the government.

We have to remember that much of the president's economic program does not even go into effect until October. The multitude of private-sector decisions affecting the whole cycle of capital spending, job creation and consumer confidence is only beginning now. Nowhere is there a magic economic wand in hiding for working short-term miracles. But there is a better remedy—the present economic policy, backed by a resolute will to follow it consistently as a permanent course by the administration. Certainty is the key consideration. We are going through some classic withdrawal symptoms now, but difficult adjustments are made easier if there is certainty of policy.

When the president's program goes fully into effect, growth in federal spending will be cut to about one-third of the rate of the last three years, and personal and business income taxes will drop significantly as a share of the GNP. Meanwhile, the Federal Reserve will be gradually reducing the expansion of money and credit.

Some of the results will begin to be recognized soon. First, this administration inherited 13 percent inflation; but during 1982 as a whole, inflation should not exceed the 8 to 9 percent range. If this prediction is accurate, it will mean a 30 percent drop in inflation—and this drop is just beginning to be understood by the public. (Imagine the publicity if the inflation rate had increased by a quarter.) As this trend continues, it will have important implications for wage increases, which have been outracing productivity gains.

Second, productivity itself will improve, which should further help competitiveness.

Third, after years of shifting policy and increasing inflation, the withdrawal symptoms, while tough, are not going to be serius enough to push the economy into a prolonged downturn.

As a matter of fact, high interest rates are the last remaining obstacle to economic recovery. If the president's latest budget cuts, announced in his address last Thursday, are enacted by Congress, the deficit will come down and interest rates will decline. The credit-sensitive areas will be hurting until interest rates do decrease; but decrease they will when the financial markets understand the fact that the Reagan administration will win its battle to hold down government spending and over-expansionary money growth.

[From the Washington Post, Sept. 27, 1981]

IT WON'T FAIL

(By George F. Will)

Fiscal and monetary policy must be managed together in a consistent manner. We intend to do just that. The financial markets are currently underestimating our resolve; they will correct this judgment as we act. The instant euphoria after the passage of the tax and budget bills should have been and is being tempered with the realization that there was much left to do. The instant skepticism before the program has been tried should be tempered with the understanding of how much has been done.

Businessmen, the job-creators, definitely believe the president's policy will work. The effects of their confidence will be apparent next year.

This is no time to weaken, as past administrations did at the first sign of trouble. We need resolve and consistency of policy, not the instant gratification that leads to future trouble. This area of resolve is perhaps where the administration is most underrated by the financial markets. It can't be measured; it is there or it isn't. It is there—this president has a cast-iron backbone.

We have the resolve and, if we keep it as a nation, we will look back on the present as a period of base-building for growth in the next three years.

The president dipped his pen in his enchanted ink and called the nation to order Thursday night. He did not again turn the public's bones to water—such raptures are for newlyweds, and hence are things of the past. But he did four useful things.

At a moment of national nervousness, not to say neurosis, about economic arcana, the president came front and center to show (as E.M. Forster said) that "keeping calm and cheeful is one of one's unshakable functions."

Second, he cauterized the Social Security issue, which could have turned the 1982 election into a referendum on the Republican "attack" on Social Security. The proposal to put off painful choices until after a bipartisan study is mandatory politics (there being no moral obligation to walk off a cliff). It also is a venerable Washington tradition. It is a combination of the Scarlett O'Hara Doctrine of Government ("I'll think about it tomorrow") and the "Annie" Hypothesis ("Tomorrow is always a day away").

Third, the president reaffirmed his determination to press for reductions in a range of other entitlement programs. An understandably skeptical financial community is watching for evidence that government can modify promises that were made improvidently. And the financial community is watching for evidence that this president can avoid the paralysis that has afflicted most recent presidents. (The proposed AWACS sale is a threat to economic health because it may end with a presidential defeat that would be seen in financial as well as diplomatic circles as evidence that the United States still is not led by its president but by Congress, a fractious committee of 535.)

Fourth, the president focused attention on something the public understands and likes: cutting government payrolls. In this regard, it was interesting that the AFL-CIO, while staging "solidarity" rallies does demonstrate class division—divison within the labor movement. The division is between blue-collar workers and the "new class" white-collar workers of the public employees' unions. The latter are left-wing, shrill—and directly threatened by the president's program. Blue-collar workers know they pay taxes that pay for white-colalr workers, with whom they feel something less than "solidarity." Tennyson and Browning would die in white-tie, and some people may think Reaganites wear black-tie when cutting the budget. But the public is a lot angrier about "bureaucrats" than about Betsy Bloomingdale's parties.

It is reported that many congressmen are not so much angry at David Stockman as they are "sick and tired" of him. That does them no credit. Perhaps never in American history has an executive branch appointee been so indispensable to so much. Had he not been available for his job, the president's program would not have begun moving until May, and would not have moved far by next May. If the markets are jittery about Reaganite action, imagine how they would be in the face of inaction—in a fifth year of drift.

Some congressmen resent Stockman not because he is a constant bringer of bad news and poser of hard choices, but because he has risen above his—or their—station. Washington is a steep social pyramid, and many congressmen have little engines fueled by envy of a few who rise from anonymity—especially those whose rise is the merited result of industriousness in the service of imagination.

Stockman is guilty not only of precocity but of coherence. He understands that a great nation's economy is like a Rubik's Cube. It has six sides, and you have to fix all six simultaneously. Congress is almost systematically incoherent, unable (when not just unwilling) to consider how one thing leads to, or is connected to, two thousand others.

Stockman is the sharp chisel the president needed for sculpting new politics from the granite of government inertia. Like a chisel, Stockman is sharp because he is narrow at the cutting edge. That is not to say he is intellectually narrow. He has reflected more profoundly than most about broad questions of social policy. To say he is narrow at his cutting edge is just to say he is, of necessity, tightly focused. Cutting is his job.

A chisel takes a pounding, and wears out. But that outcome is, I pray, a long way off, and before it happens Stockman will have set a standard of public service at which most subsequent servants will shoot in vain.

"Everything," said Dostoevski, "seems stupid when it fails," Reagan's program will seem stupid if (which I do not expect) it fails. Meanwhile some of Stockman's critics resemble the British cavalry officer who was said to be so stupid even some of his fellow officers noticed.

[From the Washington Post, Sept. 28, 1981]

Direction Seen More Important—Stockman Discounts Deficit Size

(By John M. Berry, Washington Post Staff Writer)

The precise size of the budget deficit in 1982 is not as important, David A. Stockman said yesterday, as making sure "the direction of the deficit [is] steadily down this coming year and in subsequent years."

However, Stockman, director of the Office of Management and Budget, denied a report that President Reagan would be willing to settle for only $8 billion to $9 billion of the $13 billion worth of spending cuts he requested last week. The president also asked for $3 billion in tax increases to hold the 1982 deficit to $43.1 billion.

Administration officials expect the deficit for the 1981 fiscal year, which ends Wednesday midnight, to be close to their mid-July estimate of $55.6 billion. Yesterday Stockman, interviewed on "Face the Nation" (CBS, WDVM) about whether aiming for a specific deficit figure was critical, said, "You don't have to hit 42 or 45. The point is the direction" of the deficit.

With no new spending cuts or tax increases, next year's deficit would rise by several billion dollars. Therefore, cuts considerably smaller than $13 billion could still meet the "direction of the deficit" criterion.

But Stockman discounted such arithmetic, noting that in recent years spending has turned out to be much higher than expected at the beginning of a year. "As we move through the year, we're going to find further examples of unplanned spending, overruns, bills coming due . . . And so we have to have a margin for error in this," he said.

"The only thing that we do know is that every month, every quarter the estimates get bigger and that if we sit on our hands and acquiesce, the problems will get out of control."

Two Democratic senators, Ernest F. Hollings of South Carolina and Daniel Patrick Moynihan of New York, said in an interview of "Issues and Answers" (ABC, WJLA) that Congress would not go along with the latest round of cuts partly because Reagan would not get solid Republican support.

In particular, a group of moderate Republicans known as "gypsy moths" would not go along because they believe the cuts would violate agreements by the president not to reduce spending further in certain programs, Hollings said.

Stockman would not respond directly to questions on the same point but he did not challenge a statement by a questioner that the OMB director "as much as assented . . . that you did renege on a commitment not to cut some of these programs further. . . ."

Instead, Stockman declared, "I think given the kind of fiscal situation that we face—a budget that just has enormous momentum—that we never can promise that a program will not be cut next year or the year after."

The OMB director called getting the budget deficit down "our most urgent and the highest priority problem." Argued Stockman, "The deficit is too big. The federal treasury is borrowing too much money. It's elbowing everyone else out of the market and driving interest rates up to intolerable levels."

Hollings and Moynihan agreed that the size of the deficit is driving up interest rates, but said the only sure way to reduce the federal red ink is to have smaller personal income tax cuts in future years than those now set to occur, and to rescind some $12 billion worth of tax cuts for the oil industry.

"The issue is, there is no revenue there," Moynihan said. "And the answer is to stretch out the tax cuts . . . Stretch out the tax cuts in ways that anyone serious about the economy can see that a balanced budget is possible in '84."

THE NEW YORK TIMES, FRIDAY, SEPTEMBER 11, 1981

What the Bond Market Wants

Robert L. Shomaker
Manager, Goverment Bond Trading Dept., Paine Webber
"There are firms all over Wall Street that have had their earnings decimated this year because they bought bonds long."

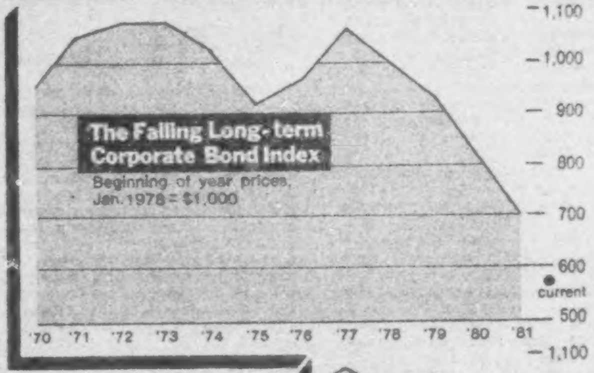
Thomas Johnson
Executive vice president, Chemical Bank
"The Reagan administration forecast a balanced budget based on unrealistic projections of growth and interest rates, and the bond market knows it."

Leon J. Kervelis, Jr.
Manager, Municipal Bond Research, Merrill Lynch
"The bond trader today is not a supply-sider and not monetarist. He's a pragmatist."

Seth Glickenhaus
Director, Glickenhaus & Co.
"Anyone who buys a bond today to hold for more than five years is out of his mind."

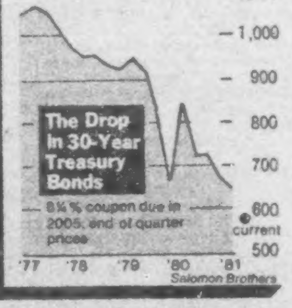
Felix Rohatyn
Partner, Lazard Frères.
"The bond market today can be divided into two categories: the general disaster and the total shambles."

George Poliszczuk
Vice president, Mellon Bank
"I can assure you that my clients will not chastize me if I forego the opportunity to invest in long-term bonds."



The Falling Long-term Corporate Bond Index

Beginning of year prices, Jan. 1978 = $1,000



The Drop in 30-Year Treasury Bonds

8¼% coupon due in 2005, end of quarter prices

Salomon Brothers

The New York Times / Sept. 11, 1981

Proof Sought Inflation Will Be Controlled

By THOMAS L. FRIEDMAN

The bond market has collapsed so badly in recent months that dealers no longer make any effort to mask their pessimism. Requests to discuss the bond market with traders are met with such responses as: Call back next year. What bond market? Or, are you wearing a life preserver?

"The bond market today is in the greatest bear market in the history of the United States," said Seth Glickenhaus, director of Glickenhaus & Company, investment advisers, and a bond trader for 40 years.

"We will not buy a bond beyond a five-year maturity for our clients, except for speculation purposes. Anyone who buys a bond today to hold for more than five years is out of his mind and you can quote me on that."

Tough talk, but the figures bear it out. According to Salomon Brothers' investment bank index, on Jan. 1, 1977 — when the bond market reached its peak — an average 25-year corporate bond sold for $1,063. On Sept. 1, 1981, that bond sold for $573.60, an all-time low. The 8¼ percent 30-year Treasury bond due in 2005 fell from $1,096 to $593 during the same period.

As bond prices fell, so did the number of new issues. Corporate bond offerings, which usually average about $3 billion a month, have plunged to the $350 million-to-$400 million rate recently. Even those bonds could only be sold at record high interest rates, some in excess of 17 percent.

"To say what Howard Baker and Robert Michel did, that the financial markets are in some kind of conspiracy to keep up interest rates is so ridiculous it leaves me speechless," said Robert L. Shomaker, manager of the government bond trading department for Paine, Webber, Jackson & Curtis Inc., referring to remarks made on Wednesday by the Senate majority leader, Howard H. Baker Jr., and Robert H. Michel, the House Republican leader. "There are firms all over Wall Street that have had their earnings decimated this year because they bought bonds long, thinking that Reagan would get interest rates down," he added.

Bonds are traded by investment banks, trust managers, pension funds and insurance companies, tied together by telephone and computers in a vast multibillion-dollar-a-day market. Since the interest, or coupon rate, on a bond is fixed at issuance, bond prices rise and fall to reflect current interest rate levels.

For example a $1,000 bond issued at 10 percent will pay $100 in annual interest throughout its life, which could be from 30 days to 40 years. If, however, interest rates rise to 20 percent, the bond's value will be halved — a scenario that has been played out frequently in the past two years.

Traders say that many investors, having squandered millions of dollars

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in the past two years riding the bond market to the bottom while waiting for the Government to curb inflation and protect the value of bond coupons, have simply lost faith in the credibility of long-term debentures — not to mention Presidential promises.

Anti-Inflation Proof Sought

Many portfolio managers report that they will not re-enter the long-term bond market — except for peak yields — until they have "tangible" proof that the Reagan economic policies will not be inflationary. But there's the rub. They uniformly view the President's expansionary tax cuts and defense spending as running head-on into the Federal Reserve's policy of monetary restraint, making for a bond trader's nightmare: high inflation and high interest rates.

Even if the President is able to harmonize his policies with those of the Fed, some traders argue that the long-term bond market will never really recover. Investors, they say, are coming to realize that Western governments are simply unwilling to administer the deflationary medicine — in the form of lower transfer payments, such as Social Security, and government spending — required to keep inflation down long enough to protect the payout on a 30-year debenture.

"People came into the bond market because they were told by a succession of governments that everything will be O.K. and that inflation will be whipped," Mr. Shomaker said. "Then they watched while one week after they bought a bond it was sold for less. People got burned too many times. They are no longer willing to take the leap of faith involved in buying a bond. We have traditional customers say to us now: 'Don't even show me a bond. I don't even want to see it.' "

The bond market today, said Felix Rohatyn, a partner at the Lazard Frères investment bank and chairman of New York's Municipal Assistance Corporation, can be divided into two categories: the "general disaster" category, consisting of taxable corporate and government issues, and the "total shambles" category of municipal bonds. Both have suffered badly from the economic policies of the Reagan Administration, but each in a different way.

The taxable bond market, which companies depend on to finance their growth and which the Federal Government uses to finance its deficit, is hurting primarily from the perception that the Reagan Administration's estimates of its borrowing needs for the next three years have nothing to do with reality.

"The Reagan Administration forecast a balanced budget based on unrealistic projections of growth and interest rates, and the bond market knows it," said Thomas Johnson, executive vice president of Chemical Bank's Treasury group. The Administration, he said, was projecting that the financing costs on its deficit would average less than 10 percent and that the economy would grow at a rate of 4 to 5 percent a year, making up for the revenue to be lost from the tax cuts.

The bond investors, Mr. Johnson said, expect that the cost of financing will be much higher and that the rate of growth will be much slower, producing deficits in 1982, '83 and '84 well beyond present estimates. Unless the Government sharply reduces defense and Social Security spending, he said, the Treasury's borrowing requirements will continue to put heavy pressure on the debt markets, forcing the Fed to maintain its policy of tight money. "A horrifying spectacle for any bond trader," Mr. Johnson said.

Tax Cuts a Factor

The market for municipal bonds, where state and local governments raise capital to finance everything from highways to utilities, is not only undermined by the general wariness about Mr. Reagan's economic policies, but also by specific provisions of the new tax code. The cuts in the corporate and individual income tax rates have obviated the need for many investors to shelter income in tax-free municipals. In addition, the new tax-free savings certificates provide an attractive alternative to municipals for the small investor.

So what does the bond market want from the President?

"Tangible evidence," declared Leon J. Karvelis Jr., manager of municipal bond research at Merrill Lynch. "The bond trader today is not a supply-sider and not monetarist. He's a pragmatist," he said. "If he represents an institution, he's got a boss and investment committee that he has to answer to. Right now his boss is saying to him: 'Remember those bonds you bought the last two years? Well, we got killed on them.' That guy isn't going to act again until he has hard proof that the economy is going the right way."

According to George Poliszczuk, vice president in charge of fixed-income investments for the trust department of Pittsburgh's Mellon Bank N.A., tangible evidence would be an inflation rate running at 5 to 6 percent for a sustained period.

"I can assure you that my clients will not chastise me if I forgo the opportunity to invest in long-term bonds until it is clear that the Government's economic recovery program is going to be disinflationary. Until then," he added, "we have decided to shorten up our portfolio. All new commitments and proceeds from sales are going into bonds of maturities less than five years, usually a lot less."

The outcome of the current Administration debate over defense spending and the overall budget will be "crucial" for the future of the bond market, said Virginia Dwyer, treasurer of A.T.& T., which issues more debt than any corporation in the world.

"One reason the bond market is so depressed now is because there are so few players," Miss Dwyer said. "So it reacts with enormous volatility to the slightest changes in perception. There are an awful lot of investors sitting on the sidelines waiting to see if the budget will be balanced and inflation brought under control, before they commit their money again."

Few bond traders said they could see the light at the end of the tunnel. Even if the Government does get its spending down, they ask, will it be enough to make room for the tremendous pent-up demand from institutions waiting to issue debt? Or, they wonder, has inflation become so endemic to our society that we are slowly becoming like Europe, where no one will buy a long-term bond?

"The Administration is having to play catch-up ball with the markets," Mr. Rohatyn said, "and that can be frustrating. When you try to play catch-up ball with them you can get into a situation where nothing you do ever turns out to be quite enough."

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Analysis

Why Reagan Faces Uphill Fight on Wall Street

Huge deficits and surging interest rates have made the President's program suspect. Result: Demand for massive new budget cuts.

Scarcely a month after ramming his economic-recovery plan through Congress, President Reagan finds himself looking for new ways to win over a growing chorus of skeptics.

Not even the promise of details of big new budget cuts—including previously untouched defense spending—has yet to calm the fears in the financial markets. Stock prices have slid dramatically in the wake of forecasts of huge federal deficits.

From April through September 4, the Dow Jones industrial average has dropped more than 160 points—half of that in the month following passage of Reagan tax and budget reductions.

To rebuild investor confidence, a Wall Street alarmed by high interest rates is asking the President to trim still more billions in federal spending—at a time when the administration had hoped to move on to other matters.

Why is the financial community jittery over what many business leaders view as the most pro-investment economic policy in decades? "Wall Street is worried about the deficits," sums up Jack Lavery, chief economist for Merrill Lynch Economics in New York.

In its haste to approve the Reagan package, critics say, Congress voted tax cuts totaling 282 billion dollars through 1984, while lopping off only 35 billion in spending for the fiscal year that begins October 1.

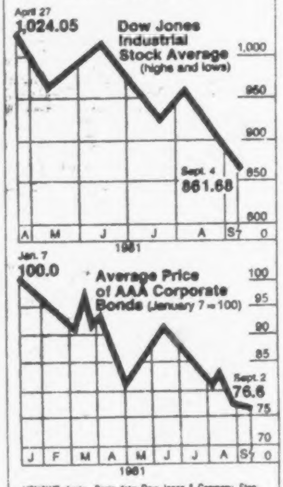
"Cuts in perpetuity." What's more, lawmakers approved an indexing provision, to begin in 1985, that would protect individuals from much of the tax burden resulting if inflation pushed them into higher brackets, but it would also deprive the Treasury of billions of dollars in revenues. In effect, says economist Richard B. Hoey of Bache Halsey Stuart Shields, Inc., indexing provides "tax cuts in perpetuity without budget cuts."

With this wide gulf between tax and spending reductions, experts fear a rekindling of double-digit inflation. "The outlook for the budget keeps getting worse," says economist Lawrence Chimerine of Chase Econometrics in Philadelphia. "The administration has understated spending all along, and now it seems to have understated the revenue loss from the tax cut."

Rather than the 42.5-billion-dollar deficit projected by the administration for the year beginning October 1, Chimerine predicts that the government will be more than 70 billion in the red when the year ends, with even bigger deficits to follow. Many others agree.

What can be done to reassure Wall Street? Alan Greenspan, who was President Ford's chief economic adviser, says that Reagan must prove his willingness to carve an additional 30 billion to 50 billion annually from the budget in fiscal years 1983-86.

Investor Jitters



USN&WR charts—Basic data: Dow Jones & Company, Standard & Poor's Corporation

That's a tall order. But the President seems determined to give it a try. To allay Wall Street's concern, the White House is considering slashing defense spending by "up to 30 billion" over the next two years to achieve a balanced budget in 1984.

This fall, the Reagan team also is expected to unveil another attempt at reforming the costly Social Security system. There is talk, too, of cuts in health and housing programs.

In addition, the administration plans to ask most government agencies in the coming year to hold spending 10 to 15 percent below the level recently authorized by Congress. In all, the White House talks about producing at least 75 billion dollars of additional budget reductions to balance the budget by 1984.

Those reductions, which would almost certainly meet stiff opposition in Congress, are just what Wall Street is looking for. At the very least, says Richard Hoffman, chief investment strategist at Merrill Lynch, Pierce, Fenner & Smith, the President must show he is willing to take on the two "political fireballs" of defense and Social Security.

Inflation warning. Without more budget cuts, Wall Streeters warn, government spending—and the borrowing to finance it—will fuel inflation and force the Federal Reserve System to continue its tight grip on the money supply.

The Fed's policy has kept interest rates at record-high levels, creating havoc for businesses of every sort and hampering expansion. A recent small drop in the prime rate—the interest banks charge their best customers—was read by analysts as a mere technical correction and not a sign of a real decline in rates.

Unhappy business leaders are urging the White House to pressure the Federal Reserve to ease its monetary policy, a step that the President is reluctant to take because it would be taken as a signal of an end to the fight against inflation.

Still, if business does not pick up sharply, the administration will not be able to reap the harvest of rising tax revenues that it had been counting on to help balance the budget.

In short, the pressure is on the President to roll up his sleeves once again and take on Congress in another tough bout over budget cuts.

By MONROE W. KARMIN

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The Economic and Budget Outlook:
An Update

September 1981

A Report to the
Senate and House
Committees on the Budget

As Required by Public Law 93-344

NOTICE
There Should Be No Release
of This Document Until
9 a.m. (E.D.T.)
Thursday, September 10, 1981

CONGRESS OF THE UNITED STATES CONGRESSIONAL BUDGET OFFICE

PREFACE

The Economic and Budget Outlook: An Update is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations. The report was prepared by George R. Iden, Joan D. Schneider, Frank S. Russek, Jr., Stephen H. Zeller, Robert A. Dennis, Peter M. Taylor, Christopher D. Kask, Marvin M. Phaup, Jr., Joseph A. Ritter, John W. Straka, David M. Santucci, and Naif A. Khouri, under the direction of William J. Beeman and Lloyd C. Atkinson. Chapter IV was prepared by CBO's Budget Analysis Division under the direction of James L. Blum with the assistance of Rosemary Marcuss of the Tax Analysis Division. Robert L. Faherty and Francis S. Pierce edited the manuscript. Debra M. Blagburn, Dorothy J. Kornegay, and Marsha L. Mottesheard typed the many drafts. Art Services, Inc., prepared the graphic figures.

Alice M. Rivlin
Director

September 1981

CHAPTER I. INTRODUCTION AND SUMMARY

The updated economic forecast of the Congressional Budget Office (CBO) shows substantial improvement in the economy compared with the lackluster performance of recent years. The slowing of inflation that began in the first half of 1981 is projected to continue into 1982. Real growth is expected to pick up late in 1981 and to be strong in 1982. The major reasons for the projected improvement in economic growth are the moderation of inflation and the reduction in taxes contained in the Economic Recovery Tax Act of 1981.

This forecast of strong real growth and moderating inflation depends critically on two highly uncertain factors. First, the economic projections assume that there will be no upsurge in commodity prices, such as the shocks in food and fuel prices that contributed to the economy's poor performance in the last several years. Second, money growth, consistent with Federal Reserve targets, could prove to be incompatible with strong economic growth.

Even with the projected improvement in the economy, CBO anticipates a budget deficit of about $65 billion in fiscal year 1982, declining gradually to about $50 billion in fiscal year 1984. These projections assume the spending policies of the First Concurrent Resolution on the Budget for 1982, which include still-unspecified spending cuts in 1983 and 1984. The CBO projections thus indicate that sizable spending cuts or revenue increases beyond those contemplated in the first resolution would be needed to achieve the target of a balanced budget in 1984.

The CBO Economic Forecast

Economic activity has been sluggish recently and is expected to show little or no improvement until the end of 1981. Correspondingly, for the remainder of the year, the unemployment rate is likely to remain near the 7 to 7-1/2 percent range experienced since the beginning of the year. Although inflation, as measured by the Consumer Price Index (CPI), may worsen a bit for a while before it gets better, by year's end a reduced pace of inflation should be in evidence. Interest rates are also expected to begin moving downward later in the year in response to the improved inflation picture.

The CBO economic forecast for 1982 indicates that real growth will be strong, compared with that in 1981 and in the last several years. Inflation is expected to continue to decelerate. From the fourth quarter of 1981 to the fourth quarter of 1982, real gross national product (GNP) is forecast to increase by about 4 percent, while inflation, as measured by the GNP implicit price deflator, is projected to moderate to a rate of about 7 percent. Interest rates, although lower than in 1981, should remain high in 1982 because of reduced money growth and strong credit demands. The unemployment rate is also expected to turn down in 1982 (see Table 1).

TABLE 1. THE CBO FORECAST

	Actual	Projected	
Economic Variable	1979:4 to 1980:4	1980:4 to 1981:4	1981:4 to 1982:4
Nominal GNP (percent change)	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (percent change)	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (percent change)	9.8	7.6 to 9.6	6.0 to 8.0
Unemployment Rate (percent, fourth quarter)	7.5	7.1 to 8.1	6.6 to 7.6
3-Month Treasury Bill Rate (percent, calendar-year average)	11.6	13.5 to 15.5	11.4 to 13.4

The strong growth projected for 1982 is a consequence of the slowed pace of inflation and the tax cut. The moderation of inflation is expected to reduce prices faster than wages thereby stimulating real income growth, which in turn will lead to stronger demands. At the same time, with less inflation, the assumed monetary policy will accommodate more real growth.

In the years beyond 1982, CBO assumes that inflation will continue to decelerate; real growth will remain relatively strong; interest rates will continue their downward trek; and the unemployment rate will decline somewhat. In brief, the CBO economic assumptions for the period 1982-1984 contrast sharply with the unfavorable economic developments of the past several years.

The basic outlook for economic activity--slow growth for the remainder of 1981 with improvement in 1982--has not changed since CBO's forecast of last winter. The actual pattern of real growth for the first half of 1981 was close to that anticipated by CBO's winter forecast: The very strong performance in the early months of the year was followed by substantial weakening in the spring. The projected slowness of growth for the remainder of 1981 has not changed significantly, largely because interest rates have remained high--even somewhat higher than in the CBO winter forecast.

On the other hand, inflation has moderated more than projected earlier. This has improved the outlook for economic activity as well as for inflation since CBO's winter forcast. The principal reasons for the improved inflation rate during the first half of 1981 were the very favorable price developments in the food and energy sectors and a higher value of the U.S. dollar on the world's currency exchanges. These favorable price "breaks" were not foreseen by forecasters six months ago. The CBO forecast of continued improvement in inflation is based on the assumption of no adverse movements either in world commodity prices or in the dollar exchange rate over the near term. Moreover, the reduced inflation momentum is expected to slow wage inflation and reduce interest rates, outcomes that make room for higher real growth and reduced unemployment rates.

Recognizing the critical importance of commodity prices in the CBO forecast highlights the elements of uncertainty involved in it. Food and energy prices, and the foreign exchange value of the dollar, have historically been volatile. Thus, if poor weather, unrest in the Middle East, or other uncontrollable factors should once again cause sharply increased food or energy prices, the economic outlook would be much less optimistic. On the other hand, a decline in energy prices would have a favorable impact on the economy.

Another area of uncertainty concerns the relationship between economic activity and money growth. Some analysts, apparently including the Federal Reserve, argue that the Federal Reserve's targets for money growth are not consistent with strong economic growth, given the rates of inflation projected by most forecasters. The CBO forecast may be optimistic on this issue, but--given the projection of a decline in inflation and prospective changes in financial regulations and institutions--not overly optimistic.

The Budget Outlook

The First Concurrent Resolution on the Budget for Fiscal Year 1982 assumed large tax cuts, sharply reduced growth in federal spending, and a reallocation of resources from nondefense to defense spending. The enactment of both the Omnibus Budget Reconciliation Act and the Tax Act of 1981 went a long way toward achieving the goals of the first resolution, though additional spending cuts will be required to achieve the deficit targets. Implicit in the first concurrent resolution targets are additional savings--over those in the Reconciliation Act--of about $15 billion in 1982, about $35 billion in 1983, and about $50 billion in 1984. (These figures include unspecified spending reductions of $20 billion in 1983 and $28 billion in 1984.) Even with these spending cuts, which are included in the CBO spending estimates, CBO anticipates a fiscal year 1982 budget deficit of about $65 billion (see Table 2). The deficit is projected to decline gradually thereafter to around $50 billion in fiscal year 1984. Nevertheless, if the spending cuts are realized, the deficit would be greatly reduced relative to GNP--from nearly 2 percent of GNP in fiscal year 1982 to about 1 percent in 1984, according to CBO's projections.

Comparison of CBO and Administration Economic and Budget Forecasts

Although the CBO forecast suggests that the economy's performance will improve sharply in 1982, CBO is not as optimistic as the Administration. In its Mid-Session Review, the Administration suggests that real growth through 1984 will be more rapid than CBO's projected increase, and that the unemployment rate will be slightly lower. Although the Consumer Price Index shows less inflation in the Administration's projections than in CBO's projections, the inflation projections are quite similar, when measured by the GNP implicit price deflator. Interest rates, on the other

TABLE 2. CBO AND ADMINISTRATION ECONOMIC AND BUDGET OUTLOOKS, 1981-1984

	1981	1982	1983	1984
	Economic Projections (calendar years, in percent)			
Real GNP Growth				
Administration	2.6	3.4	5.0	4.5
CBO a/	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator				
Administration	9.6	8.0	7.0	6.0
CBO a/	9.1	7.7	7.0	6.6
Unemployment Rate				
Administration	7.5	7.3	6.6	6.2
CBO a/	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate				
Administration b/	13.6	10.5	7.5	6.8
CBO a/	14.5	12.4	11.4	10.1
	Budget Projections (fiscal years, unified budget basis, in billions of dollars)			
Revenues				
Administration	605.6	662.4	705.8	759.0
CBO c/	605	655	698	748
Outlays				
Administration	661.2	704.8	728.7	758.5
CBO c/	665	720	753	798
Surplus (+) or Deficit (-)				
Administration	-55.6	-42.5	-22.9	+0.5
CBO c/	-60	-65	-55	-50

SOURCES: Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ According to the Administration's Mid-Session Review, page 69, "These projections assume, by convention, that interest rates are linked to the rate of inflation. They are not forecasts of interest rates."

c/ Midpoints of CBO projection ranges. Assumes the spending policies of the First Concurrent Resolution on the Budget for Fiscal Year 1982, with the tax estimate adjusted to reflect the provisions of the Economic Recovery Tax Act of 1981.

hand, are substantially lower in the Administration projection. Table 2 highlights the differences between the CBO and Administration economic and budget projections. The differences in the budget estimates are largely on the spending side. In 1984, for example, higher outlays account for about 80 percent of the $50 billion difference in forecasts of the deficit.

Conclusion

The CBO economic and budget forecasts, which are less optimistic than those of the Administration, depend heavily on a number of highly uncertain developments. The economic projections contain favorable assumptions about food and fuel prices and about the response of the economy to reduced money growth. In addition, the budget projections incorporate large spending cuts not yet specified or enacted. With respect to economic activity, the downside risks now seem to be substantial. Under an alternative set of less favorable, but not unreasonable, economic and spending assumptions, the federal budget deficit in 1984 could exceed $50 billion by a considerable margin.

The economic impact of large deficits continuing through 1984 cannot be precisely estimated. On the one hand, if large deficits arise from a failure to achieve the spending cuts during a period of strong demands, the budget could become quite expansionary and thus contribute to inflation. If, on the other hand, they occurred because of weaker growth in demand, the enlarged deficit would not contribute significantly to inflationary pressures. Fiscal measures can also have favorable effects on productivity, which would reduce the adverse effects of deficits. Nevertheless, continued large deficits would imply higher interest rates than otherwise, which in turn would tend to deter investment and thereby reduce long-run growth.

CHAPTER II. RECENT ECONOMIC DEVELOPMENTS

The U.S. economy turned in a roller-coaster performance during the first half of 1981. The opening quarter saw real GNP rise at an 8.6 percent annual rate, followed in the second quarter by a 2.4 percent decline. The negative second quarter has caused some speculation that the economy may have moved into yet another recession; but this is not supported by evidence of major imbalances in the economy, such as excessive inventories or overbuilding of structures, that would lead one to project a prolonged decline in real economic activity. Indeed, there appear to be considerable pent-up demands for housing and other durable goods that could be released if financial conditions improve substantially. There is risk, of course, that continuation of present financial conditions could cause more sluggish growth than is now forecast by CBO. Barring such adverse developments, a deep recession in the near term is unlikely.

GNP GROWTH

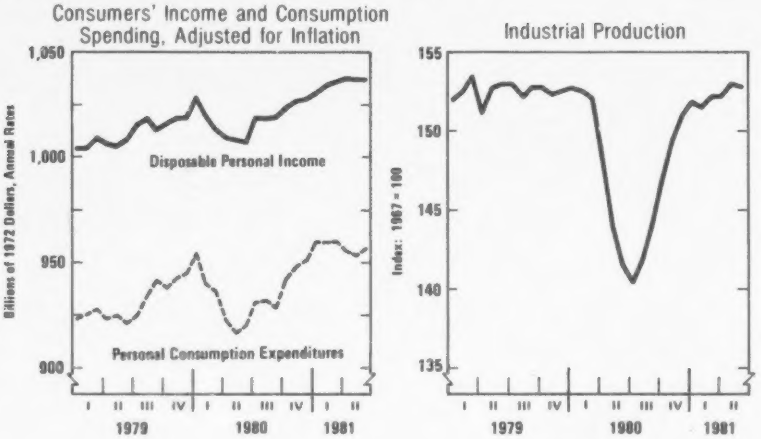
Viewed in isolation, the inordinately large increase in real GNP in the first quarter and the negative growth in the second provide a distorted picture of the economy for the first half of 1981. A more accurate picture is this: Recovery from the very sharp drop in economic activity in the first half of 1980 continued at a robust pace through the fourth quarter of 1980 and into the first month or so of 1981, but slowed appreciably thereafter; since January, the economy has essentially been moving sideways at a level close to the peak value it attained at the beginning of 1980. Monthly data for real personal consumption expenditures and industrial production, displayed in Figure 1, tend to confirm this view.

The peculiar patterns of change of GNP and its components for the first half of 1981, documented in Table 3, can be partly explained by various "special" economic and statistical factors.

- The 8.6 percent rate of growth of real GNP registered for the first quarter of this year overstates the growth that actually occurred during that quarter. Although economic growth during much of the first quarter was negligible, the

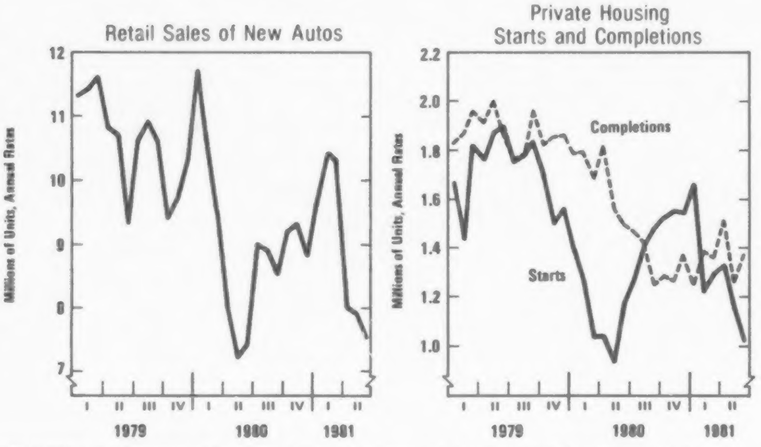
Figure 1.

Selected Indicators of Economic Activity



Consumers' Income and Consumption Spending, Adjusted for Inflation

Industrial Production



Retail Sales of New Autos

Private Housing Starts and Completions

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Federal Reserve System, Board of Governors.

TABLE 3. INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rate, unless noted)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
Real GNP	3.1	-9.9	2.4	3.8	8.6	-2.4
Final sales	3.1	-10.4	4.1	4.4	6.9	-5.2
Personal consumption expenditures	0.8	-9.8	5.1	7.0	5.8	-2.0
Durable goods	-1.6	-43.3	21.7	21.2	24.1	-23.6
Motor vehicles and parts	12.5	-67.2	44.2	26.3	51.7	-47.8
Nondurable goods	0.2	-5.3	-1.8	6.3	4.6	2.4
Services	2.1	0.0	6.4	3.7	1.4	2.3
Fixed investment	-5.3	-31.8	2.1	15.7	10.8	-8.3
Nonresidential	2.2	-19.9	-1.5	4.0	13.3	-4.0
Structures	-1.4	-13.1	-15.3	9.0	16.6	5.1
Producers' durable equipment	3.8	-22.7	5.3	1.9	11.8	-7.8
Autos	50.8	-59.5	90.3	16.9	56.0	-41.7
Residential	-24.2	-60.2	16.0	64.2	3.6	-21.0
Government Purchases	6.9	2.5	-5.0	2.2	5.4	-5.8
Federal	18.9	11.9	-13.1	2.0	14.8	-9.0
Defense	9.8	6.2	-0.1	5.9	1.1	2.0
Nondefense	38.4	23.1	-33.1	-5.3	46.8	-27.0
State and local	0.6	-2.8	0.3	2.3	0.2	-3.8
Exports	32.0	12.3	-0.2	-7.4	13.6	-6.9
Imports	11.9	-21.9	-20.4	25.8	10.3	12.9
Change in business inventories (billions of 1972 dollars)	-0.9	1.3	-5.0	-7.2	-1.4	9.7
Real Disposable Personal Income	1.3	-4.9	4.1	2.9	3.0	1.2
Saving Rate (percent)	4.9	6.2	6.1	5.1	4.6	5.3
Industrial Production	-0.1	-19.2	-6.7	21.2	7.4	2.4
Labor Force	1.8	1.8	1.1	0.7	2.4	3.7
Unemployment Rate (percent)	6.2	7.3	7.5	7.5	7.3	7.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve System, Board of Governors; and U.S. Department of Labor, Bureau of Labor Statistics.

fact that production rose rapidly all through the fourth quarter of 1980 meant that the average level of GNP for the first quarter of 1981 was statistically much higher than the average GNP level for the fourth quarter of 1980, yielding a high rate of growth measured quarter over quarter.

- Because consumers and businesses took advantage of the sizable auto rebates that were offered mainly in February and March, consumer durable expenditures and business fixed investment in the first quarter of 1981 rose much more rapidly than would have occurred otherwise; consumer and business spending retrenched in the second quarter when the auto rebate programs were terminated. These volatile swings in real consumer and business spending for autos had negligible effects on real GNP growth in the first half of 1981 since they were largely mirrored by offsetting movements of auto stocks, the rundown of auto stocks in the first quarter being followed by an upsurge in the second. Auto production was little changed over first two quarters.

- The sharp swing in real federal government spending--up 14.8 percent in the first quarter of 1981 and down 9.0 percent in the second quarter (at annual rates)--is explained almost exclusively by peculiarities in the timing of loan commitments and loan redemptions by the Commodity Credit Corporation (CCC). Total real federal purchases less CCC outlays were virtually unchanged over the first half of 1981.

- The vigorous uptick in nonresidential construction and the more modest increase in residential investment in the first quarter of 1981 were largely the result of unseasonably warm weather.

- The increase in real non-auto business inventories contributed to growth in the early months of 1981. Its impact, however, was masked by the dramatic swings in new auto stocks--down $6.2 billion in the first quarter and up $7.3 billion in the second quarter, after adjustment for inflation.

Other statistics support the view that the economy has followed a flat trajectory since the early months of 1981. The rapid pace of real expenditures for furniture and appliances in the first quarter turned negative in the second quarter; the double-digit rate of real growth for apparel reported in the first quarter was halved in the second quarter; and the essentially flat level of real purchases by state and local governments in the first quarter was followed by negative growth in the second quarter. This pattern of essentially no growth in the economy is expected to continue in the third quarter.

Reflecting the sluggish growth of the economy, the unemployment rate changed little over the course of the first eight months of 1981, hovering in the 7 to 7-1/2 percent range throughout. CBO expects the unemployment rate to increase modestly in the remainder of the year.

The sluggish performance of the economy in the spring and summer of 1981 should occasion little surprise in view of the record high interest rates and the increasing restrictiveness of fiscal policy; what is surprising, perhaps, is that economic activity continued at a fairly high level despite the monetary and fiscal policies then in place. By most measures, fiscal policy turned restrictive in the first half of 1981, mainly because of the large increase in Social Security taxes in January and the increase in the windfall profits tax resulting from the decontrol of domestic oil prices. But the dominant policy story in the first eight months of 1981 concerns the record high interest rates that contributed to the extreme weakness in both housing and auto sales, highlighted in Figure 2.

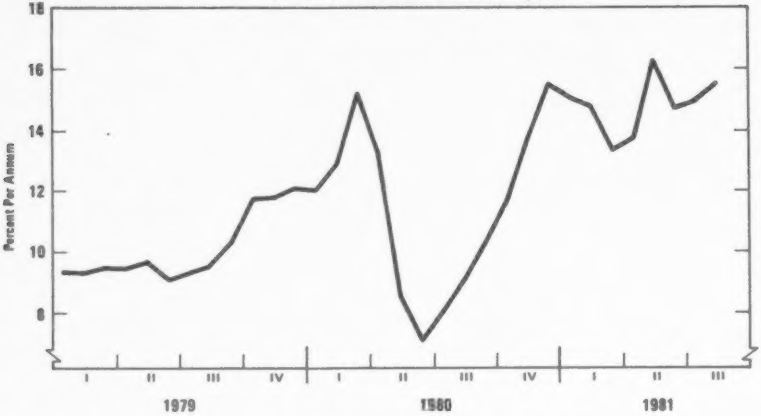
INTEREST RATES

The year began with short-term interest rates at or near record highs. They eased somewhat over the course of the first quarter, but resumed their uptrend early in the second; in early September, they were at or above the levels recorded at the beginning of the year. The pattern of change in the three-month Treasury bill rate, displayed in Figure 2, is typical. Many economists do not find this behavior of short-term interest rates surprising in view of the Federal Reserve's policies.

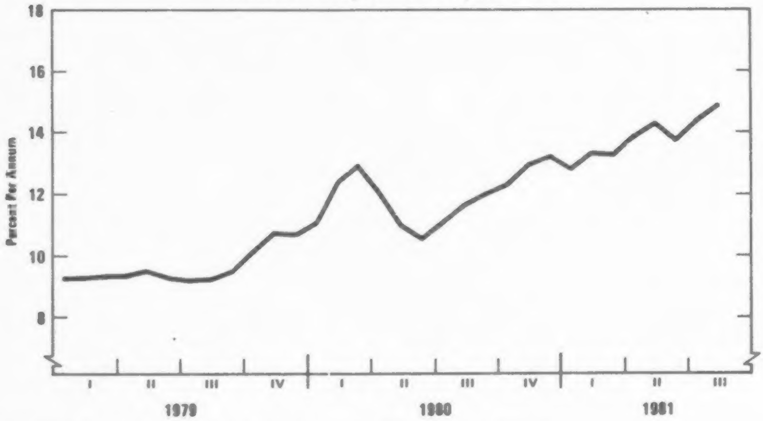
Long-term interest rates continued their upward advance through May. They eased somewhat in June but turned up again in July and continued upward through August. The continued upward movement of long-term interest rates is not easily understood in

Figure 2.

Interest Rates



Market Yield on 3-Month Treasury Bills



Yield on Moody's AAA Corporate Bonds

SOURCES: Federal Reserve System, Board of Governors; Moody's Investors Services, Inc.

view of the moderated pace of inflation. Apparently inflationary expectations have not been dampened significantly.

- The favorable developments in inflation have occurred in markets (food and energy) in which inflationary expectations may not figure prominently in the determination of the rate of price change.

- The moderation of price inflation has yet to show up in a corresponding reduction in wage inflation, as will be noted below.

- Belief in the Federal Reserve's ability to control the monetary aggregates may have been undermined, especially as a result of the volatile behavior of the money supply and interest rates during 1980.

- A great deal of emphasis is being placed on expected heavy borrowing by the federal government in credit markets. Although the reduction in the federal deficit is a goal much emphasized by the Administration and the Congress, financial markets may be somewhat skeptical that it can be achieved.

CBO expects that both short-term and long-term interest rates will soon begin to fall. With the economy continuing its lackluster performance in the months ahead and inflation improving, CBO's assumption that the growth of the monetary aggregates will be within the Federal Reserve's target ranges should be consistent with a modest decline in short-term interest rates. Between calendar years 1981 and 1982, short-term interest rates decline about two percentage points in the CBO forecast. Long-term interest rates are also expected to decline gradually in response to reduced inflation.

INFLATION

The good news in the first half of the year was the marked slowing of inflation. After advancing at a seasonally adjusted annual rate of nearly 13 percent in the fourth quarter of 1980, the growth of the Consumer Price Index (CPI) slowed in the first quarter to an annual rate of 10.8 percent, and further still in the second quarter to an annual rate of 7.5 percent. As Table 4 makes clear, the GNP implicit price deflator, the GNP fixed-weighted

TABLE 4. PRICE INFLATION (Percent change, seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
CPI-U a/	16.5	13.1	7.7	12.9	10.8	7.5
CPI-U less Food and Energy	14.8	13.9	6.9	13.2	8.9	8.9
Producer Price Index for Finished Goods	16.5	10.5	14.0	8.9	10.7	8.3
GNP Implicit Price Deflator	9.3	9.8	9.2	10.7	9.8	6.6
GNP Fixed-Weighted Price Index	9.7	9.3	9.0	10.4	10.2	8.0

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Consumer Price Index for all urban consumers.

price index, and the Producer Price Index (PPI) for finished goods showed the same kind of inflation moderation. The July increase in the CPI, 15.2 percent at an annual rate, contrasts sharply with these favorable trends, but the CBO forecast suggests that this rise represents only a temporary departure that may last only a month or two.

Why did inflation moderate so dramatically? Simply put, because of very favorable price developments in the food and energy sectors and the marked appreciation of the dollar in foreign exchange markets. In its January 1981 report, the Council of Economic Advisers anticipated a sharp acceleration in food prices during 1981--from 8.6 percent in 1980 to about 12 percent in 1981--principally because of the poor feed-grain harvests of 1980. The increased grain prices were expected in turn to cause reduced levels of meat production and dramatically higher meet prices. As it turned out, many cattle ranchers decided last winter to bypass feedlots and send some cattle directly to slaughter. This temporarily made more beef available for market and delayed until mid-1981 the expected increase in beef prices. At the same time, sugar prices in international markets fell rapidly from their peak values of last fall. Neither of these favorable movements in food prices is likely to be repeated in the second half of 1981: The reduction in beef supplies is now showing up in the form of higher wholesale and retail meat prices, and sugar prices at the wholesale level are not expected to fall any further because they are at or near their international support levels.

Largely as a result of the expected increase in retail meat prices, average food prices in 1981 should rise to a level about 8-1/2 percent higher than in 1980. For 1982, the prospects for moderation in food price increases are good because world grain harvests for the 1981 crop year are expected to be much better than those in 1980. Nevertheless, in the medium term, food prices are likely to continue to increase faster than other prices because world food demand is pressing upon agricultural capacity. The CBO forecast implies that food prices will rise about 1 percent faster than other prices in 1982.

Oil prices, too, have been falling in international markets for the past few months--a development that was not expected last winter. The emergence of an oil supply glut can be attributed to three factors:

- Slow economic growth in consuming countries;
- A relatively large drop in demand in response to last December's oil price increases, which was helped along in the United States by the decontrol of domestic oil prices, and in other countries by the sharp appreciation of the dollar that caused the foreign currency price of oil to rise despite a decline in its dollar price; and
- High oil production by Saudi Arabia and other oil-producing countries.

The softness in oil prices is expected to continue for perhaps a year. The abatement of upward price pressure is evident in the widely publicized price cuts by the United Kingdom and several OPEC producers following the August OPEC meeting. What happens to oil prices, however, will depend greatly on the production policies of Saudi Arabia and other OPEC countries.

The price path chosen for the CBO forecast assumes a resumption of world oil price increases in the second half of 1982, running at about 8 percent (slightly above the rate required to keep oil prices constant in real terms). The experience of recent years suggests that this forecast is subject to much uncertainty. A variety of circumstances, ranging from renewed unrest in the Middle East to earthquakes to violent storms in the North Sea, could disrupt oil supplies enough to push prices up much faster. A resumption in demand growth in the industrialized countries could also increase oil prices. 1/ On the other hand, a lower oil price path is also possible if there is sluggish economic growth in the developed countries, or if Iran and Iraq resume high rates of production and other OPEC countries do not reduce production correspondingly.

Finally, some moderation of inflationary pressures has occurred as a consequence of the marked appreciation of the U.S. dollar internationally--up over 23 percent on a trade-weighted basis between December 1980 and August 1981. Sluggish U.S. economic growth, historically high U.S. interest rates, and lower U.S. inflation generally have all served to raise the foreign exchange value of the dollar. For the remainder of 1981 and 1982, the dollar is expected to remain fairly stable--in part because no significant changes in inflation and real growth differentials are expected between the United States and its trading partners, and in part because U.S. interest rates are expected to remain relatively high.

WAGE DEVELOPMENTS

The deceleration of inflation in the first half of 1981 has not yet been clearly matched by a reduction in the pace of wage advance. Indeed, trends in labor costs showed only slight moderation over the course of the first half of the year, which means that underlying inflationary pressures remained strong (see Table 5). Measured in terms of percentage change from one year earlier, the Index of Average Hourly Compensation--which includes

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1/ Recent forecasts by the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) suggest that demand growth outside the United States will be very limited in the next few years.

TABLE 5. LABOR COSTS (Seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
	Percent Change from One Year Earlier					
Compensation per Hour a/	9.7	9.9	10.1	10.1	10.4	10.0
Employment Cost Index a/ b/	9.1	9.3	9.4	9.0	9.3	9.3
	Percent Change from Previous Quarter					
Average Hourly Earnings Index	9.1	10.0	9.1	10.4	9.7	8.3
Unit Labor Costs a/	9.9	14.6	5.3	10.1	7.0	8.8

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a/ Data are for the private nonfarm economy.

b/ Index for wage and salary component of compensation.

both employer contributions to social insurance and the costs of fringe benefits--rose at double-digit rates in the first and second quarters of 1981, little changed from the rate of advance in 1980. The Employment Cost Index for wages and salaries confirms the sustained high level of wage inflation observed in the compensation data: Measured in terms of percentage change from one year earlier, the Employment Cost Index has shown little change in the past 18 months. Although both of these measures showed a moderation in wage gains in the second quarter of 1981, following sharp increases in the first quarter, it is questionable whether the second-quarter decline reflects much of a moderation in wage gains. 2/

One measure of wage inflation--the Index of Average Hourly Earnings--did show moderation in the first half of 1981. This is a measure of wage trends for production and nonsupervisory personnel. It increased by 9.7 percent (at an annual rate) in the first quarter of 1981, followed by an 8.3 percent rate in the second quarter. This index slowed to an annualized rate of increase of 5.3 percent in July, but it jumped in August to a rate of 14.7 percent, virtually guaranteeing a rapid increase in the third quarter. Another labor cost statistic covering wage settlements reached in collective bargaining during the first six months of the year implied possibly more rapid wage inflation in 1981. The major collective bargaining settlements in the private sector provided for average wage adjustments of 11.4 percent for the first year of the contract exclusive of prospective wage changes that may occur under cost-of-living-adjustment clauses. This is less than the 13.9 percent rate reported for the first quarter of 1980, but is nonetheless substantial.

To date, therefore, there do not appear to have been substantial reductions in wage gains to match the reduced pace of price inflation. In large part, this reflects an effort to "catch up" with past high rates of inflation. CBO expects, however, that the growth of employee compensation will decelerate in 1982 in response to the declining inflation.

2/ Measured in terms of percentage change from one quarter to the next, the compensation statistics suggest that labor-cost inflation accelerated in the first quarter and plummeted in the second. Thus, growth of average hourly compensation in the nonfarm business sector rose from a 9.8 percent rate of increase in the fourth quarter of 1980 to an 11.6 percent rate of increase in the first quarter of 1981, followed by a 9.6 percent rate of increase in the second. This change distorts the labor-cost picture. The inordinately large first-quarter increase was attributable chiefly to the upward adjustment of both the rate and base increases for Social Security contributions that took effect in January; the second-quarter cost increase was, accordingly, much more moderate.

Recent gains in productivity growth have had some favorable effects on unit labor costs. One closely watched labor cost series is that for unit labor costs in the private nonfarm business sector (compensation per hour in the nonfarm business sector adjusted for productivity growth). After advancing at a rate in excess of 10 percent during 1980, unit labor costs slowed to a 7.0 percent annual rate of increase in the first quarter of 1981. This decline, however, was attributable almost exclusively to the 4.3 percent increase in labor productivity growth in the first quarter of 1981, the result of the unsustained increase in real GNP growth. The sharp slowdown in productivity growth to 0.7 percent in the second quarter resulted in a rebound of unit labor costs to an 8.8 percent annual rate of increase. Nevertheless, the unit labor cost picture improved in the first half of 1981. The CBO forecast presented in this report points to a continued deceleration of unit labor costs in 1982.

CHAPTER III. THE MIDYEAR ECONOMIC FORECAST

The CBO forecast, described below, anticipates a pickup in economic activity later this year and relatively rapid growth in 1982. The major reasons for the projected improvement in growth are a moderation of inflation and the reduction in taxes over the forecast period. The slowing of inflation is predicated on the considerably improved outlook for both food and fuel prices through next year. Price increases are expected to moderate faster than wage increases, thereby stimulating real income growth, which in turn will lead to stronger final demands. As inflation eases, the assumed tight monetary policy will accommodate more real growth.

This forecast, however, contains elements of uncertainty. First, the food and fuel sectors of the economy remain volatile and unpredictable. Second, the possibility remains that the Federal Reserve's announced targets for money growth may inhibit a resumption of growth in total spending in 1982. Third, the prospects for upward pressure on interest rates would be increased if Treasury borrowing is larger than projected because of the failure to achieve planned spending cuts.

BASIC ASSUMPTIONS OF THE FORECAST

Policy Assumptions. The CBO forecast is based on the following assumptions about fiscal and monetary policies through 1982:

- Total federal government spending, on a unified budget basis, is $665 billion in fiscal year 1981 and $718 to $723 billion in fiscal year 1982. These estimates embody the reductions in nondefense purchases, transfers, and grants, as well as the increases in defense purchases, included in the first budget resolution for fiscal year 1982.

- The tax policy embodies the major provisions of the Economic Recovery Tax Act of 1981. 1/ This includes a 25

1/ The economic effects of some provisions of the Tax Act, such as the All Savers Certificate, have not been estimated.

percent reduction in personal income tax rates--5 percent in October of 1981 and then 10 percent in July 1982 and July 1983--as well as the "15-10-5-3" accelerated capital cost recovery system.

- The rates of growth of the monetary aggregates are within the target ranges announced by the monetary authorities. Because of continued strong growth in current-dollar GNP, however, these aggregates are expected to lie close to the upper ends of their announced ranges.

Food and Fuel Price Assumptions. While the outlook for food and fuel prices is highly uncertain, the CBO forecast makes the following assumptions:

- Food prices increase by 8-1/2 percent in calendar year 1981 and by 9 percent in 1982, more than 1 percent faster than the overall price level.

- World oil prices remain flat through the first half of 1982 and then rise by about 8 percent for the remainder of the year.

Consequently, oil prices are assumed to place downward pressure on inflation in 1982, while food price developments are not expected to add much upward pressure over the forecast period.

THE FORECAST

The CBO current policy forecast is presented in Table 6.

- Real GNP is projected to rise by 1.5 to 3.5 percent from the fourth quarter of 1980 to the fourth quarter of 1981. Real growth is forecast to accelerate somewhat in 1982--with real GNP rising by 3.1 to 5.1 percent.

- Inflation, as measured by the implicit price deflator for GNP, is forecast to remain in the 7.6 to 9.6 percent range in 1981 and then to decelerate significantly, to the 6.0 to 8.0 percent range, in 1982.

- The unemployment rate is likely to lie in the 7.1 to 8.1 percent range in the fourth quarter of 1981 and then decline slowly to a range of 6.6 to 7.6 percent by the end of 1982.

TABLE 6. CBO'S ECONOMIC PROJECTIONS FOR 1981 AND 1982

	Levels			Rate of Change (percent)		
Economic Variable	1980:4 (actual)	1981:4	1982:4	1979:4 to 1980:4 (actual)	1980:4 to 1981:4	1981:4 to 1982:4
GNP (billions of current dollars)	2,730.6	2,982 to 3,098	3,259 to 3,516	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (billions of 1972 dollars)	1,485.6	1,508 to 1,538	1,555 to 1,616	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (1972=100)	184	198 to 201	210 to 218	9.8	7.6 to 9.6	6.0 to 8.0
Consumer Price Index (1967=100)	257	278 to 283	294 to 305	12.5	8.2 to 10.2	5.7 to 7.7
Unemployment Rate (percent)	7.5	7.1 to 8.1	6.6 to 7.6	—	--	--
3-Month Treasury Bill Rate (percent, calendar year average)	11.6	13.5 to 15.5	11.4 to 13.4	—	--	--

- o The three-month Treasury bill rate is expected to moderate later in 1981, averaging between 13-1/2 and 15-1/2 percent over 1981 and about two percentage points lower over 1982.

Most forecasters, including CBO, do not expect any significant resumption of real growth until late this year. High interest rates and weak growth in real disposable income continue to provide considerable restraint on growth. At the moment, no serious imbalances are thought to exist between output and sales, so that a large adjustment in output to remedy an imbalance does not seem likely. Negative growth in the third quarter is possible, but CBO does not project a deep or prolonged decline in economic activity. The financial sector, however, is a source of considerable uncertainty. If interest rates continue at present levels for a prolonged period, a significant number of financial institutions (particularly thrifts) may be threatened, and small business failures could become more widespread. Moreover, spending by consumers and business could be further depressed if credit conditions remain very tight.

In the CBO forecast, however, the improving inflation outlook, combined with slow growth in the economy, is expected to lead to somewhat lower interest rates over the next few months. Lower interest rates and increased real wages set the stage for a resumption of consumer and business investment spending in the CBO forecast. The expected improvement in activity will be aided by the business tax reduction, retroactive to January 1, 1981, and the reductions in personal income tax rates starting in October. But while the average level of interest rates in 1982 is expected to be well below current levels, rates will remain high and will restrain growth somewhat.

Several factors that have worked to restrain the economy in the past have recently shifted in a more favorable direction, or are expected to do so soon:

- o The deceleration of inflation is expected to lead to gains in real wages and to lower interest rates;
- o The personal income tax burden will ease in the fourth quarter of 1981 and again in mid-1982, thereby contributing to the rise in real disposable income;
- o Defense purchases will strengthen later in 1981;

- The recently enacted capital cost recovery system provides strong incentives to invest; and

- There appears to have been no speculative buildup of inventories that would necessitate a large adjustment in output.

As these factors have their effects, the pickup in 1982--while still modest by historical standards--will represent a significant improvement in the performance of the economy as compared with the last three years.

The key components of the projected recovery in real activity are:

- A marked improvement in investment spending in response to the business tax cut and the resurgence of final demands;

- A sharp upturn in housing and automobile production from current depressed levels; and

- Strong defense purchases and orders leading to higher levels of production, utilization, and investment. The buildup in defense spending is assumed to proceed without any significant "bottlenecks" through 1982.

A COMPARISON OF FORECASTS

The most recent forecasts of CBO, the Administration, and the Federal Reserve, as well as earlier forecasts by CBO and the Administration, are summarized in Table 7. The new CBO forecast reflects the recent improvement in inflation; it sees inflation, as measured by the implicit price deflator for GNP, running 1-1/2 percentage points lower in 1981 and 2 percentage points lower in 1982 than was anticipated in the CBO winter forecast. Real growth is seen as somewhat stronger in 1981, largely because of rapid growth in the first quarter, and as significantly stronger in 1982. The unemployment rate is forecast to be 0.5 percentage point lower by the fourth quarter of 1982 than was foreseen last winter. Interest rates remain very high in the new CBO forecast.

The Administration has also reduced its inflation forecast for 1981 and 1982, but by less than the CBO. Its downward revision

TABLE 7. COMPARISON OF FORECASTS MADE BY CBO, THE ADMINISTRATION, AND THE FEDERAL RESERVE (Fourth quarter over fourth quarter)

	1981	1982
Nominal GNP (percent change)		
CBO	11.2	11.5
Administration	11.8	12.9
Federal Reserve	10.3	10.9
CBO, Winter	12.1	12.1
Administration, Winter	11.0	13.3
Real GNP (percent change)		
CBO	2.5	4.1
Administration	2.5	5.2
Federal Reserve	2.3	2.5
CBO, Winter	1.8	2.8
Administration, Winter	1.4	5.2
GNP Implicit Price Deflator (percent change)		
CBO	8.6	7.0
Administration	9.1	7.3
Federal Reserve	8.3	7.5
CBO, Winter	10.1	9.1
Administration, Winter	9.5	7.7
Unemployment Rate (percent, fourth-quarter average)		
CBO	7.6	7.1
Administration	7.7	7.0
Federal Reserve	7.9	7.8
CBO, Winter	7.8	7.6
Administration, Winter	7.7	7.0
3-Month Treasury Bill Rate (percent, calendar year average)		
CBO	14.5	12.4
Administration a/	13.6	10.5
Federal Reserve	N.A.	N.A.
CBO, Winter	12.8	13.8
Administration, Winter	11.1	8.9

NOTE: The CBO estimates are midpoints of ranges of economic projections; the Federal Reserve estimates are midpoints (rounded to one decimal place) of ranges of economic projections formulated by members of the Federal Open Market Committee.

SOURCES: Congressional Budget Office; Office of Management and Budget, A Program for Economic Recovery, February 18, 1981, and Mid-Session Review of the 1982 Budget, July 15, 1981; Federal Reserve System, Board of Governors, Midyear Monetary Policy Report to Congress, July 20, 1981.

a/ According to the Administration's Mid-Session Review of the 1982 Budget, "These projections assume, by convention, that interest rates are linked to the rate of inflation. They are not forecasts of interest rates."

amounts to about one-half of a percentage point in each year. Projections for real growth are higher for 1981 and unchanged for 1982. Interest rate projections have been raised substantially in the Administration's forecast.

The differences between the CBO and the Administration forecasts have been reduced since last winter. They are now very similar in their outlook for 1981. The Administration forecast still remains more optimistic for 1982. The Administration forecast of real growth is more than one percentage point higher than the CBO projection. Its forecast of nominal GNP is also well above the CBO forecast for 1982, and its three-month Treasury bill rate, at 10.5 percent for 1982, is nearly two percentage points lower than CBO's forecast.

The Federal Reserve forecast for inflation is close to what CBO and the Administration project. Its projection for nominal GNP in 1982 is substantially lower than the Administration's and somewhat lower than CBO's. Real growth in 1982 is lower than in the CBO and Administration forecasts--by 1.6 and 2.7 percentage points, respectively--and unemployment is substantially higher.

The Federal Reserve's less positive outlook probably can be traced to its assumptions about the impact of monetary restraint on economic growth. As indicated below, however, there is considerable uncertainty about the economic impact of the Federal Reserve's announced money targets.

Two major uncertainties in the economic outlook for 1982 are the behavior of food and fuel prices and the impact of monetary policy. These topics are treated in the following two sections.

COMMODITY PRICES

Both food and fuel prices have traditionally been very difficult to predict. Their importance in the current inflation outlook means that CBO's inflation projection, and that of most other forecasters, must be treated with caution. If food and fuel prices were to increase about 10 percentage points more than assumed by CBO through 1982, they would have a significant impact on real growth, inflation, and unemployment (see Table 8).

On the other hand, developments in commodity prices might be more favorable than assumed. For example, absolute declines

TABLE 8. ESTIMATED ECONOMIC IMPACTS OF PESSIMISTIC FOOD AND FUEL PRICE ASSUMPTIONS--10 PERCENTAGE POINTS HIGHER THAN ASSUMED IN THE CBO FORECAST

Economic Variable	1982:4
Real GNP (billions of 1972 dollars)	-15 to -20
GNP Implicit Price Deflator (percent)	+1-1/4 to +1-3/4
Unemployment Rate (percentage points)	+0.4 to +0.5

in world oil prices over the forecast period cannot be ruled out. The OPEC meeting in Geneva in August 1981 indicated that oil price increases through 1982 will be lower than most forecasters had been expecting. A decline in world oil prices would have a favorable effect on economic activity.

MONETARY POLICY AND INTEREST RATES

A major uncertainty in the economic outlook is the compatibility of the Federal Reserve's monetary policy targets and rapid economic growth. The Federal Reserve, with the urging of the Administration, has indicated that the major objective of its monetary policy is to reduce inflation. The Federal Reserve is attempting to achieve this goal by a steady reduction in the growth of the money aggregates. Recently it has made some progress in this direction. The growth of the narrow aggregate, M1B, the most closely watched money target, has evidently decelerated, particularly since April. 2/ In fact, the growth of M1B Adjusted has recently been below the low end of the Federal Reserve's target range for that aggregate (see Figure 3). The growth of the

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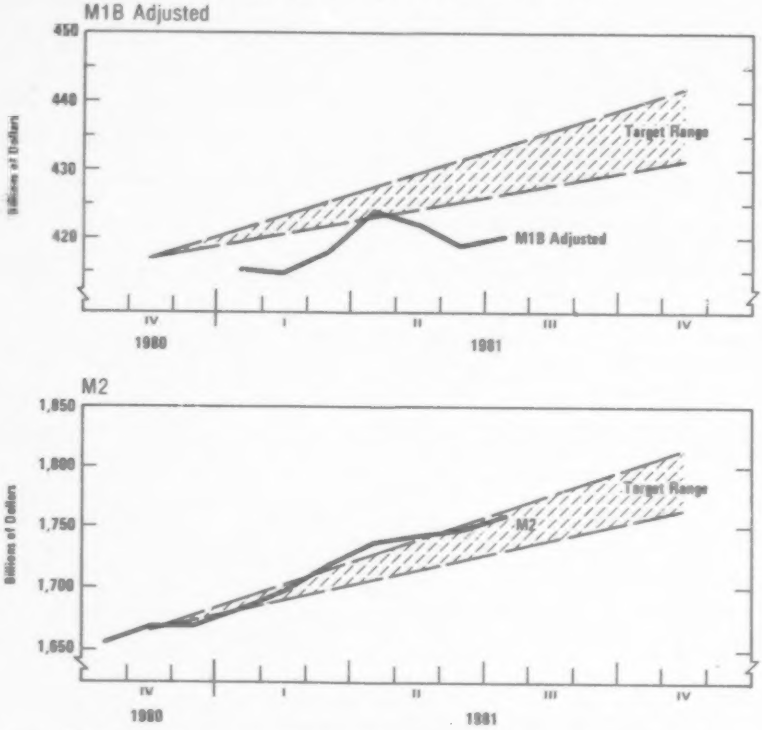
2/ For a definition of M1B Adjusted and M2, see Figure 3.

Figure 3.

Monetary Aggregates: Target Ranges and Actual Levels



M1B Adjusted

M2

NOTE: **M1B Adjusted:** Averages of daily figures for (1) demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float, (2) currency outside the Treasury, Federal Reserve Banks, and the vaults of commercial banks; (3) travelers checks of nonbank issuers; and (4) negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at banks and thrift institutions, credit union share draft accounts, and demand deposits at mutual savings banks. Adjusted by the Federal Reserve Board for major shifts into NOW accounts from interest-earning assets included in M2.

M2: M1B plus savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks, and money market mutual fund shares.

SOURCE: Federal Reserve System, Board of Governors.

broader aggregate, M2, has been much stronger. But M1B is now considered to be a better indicator of monetary policy because M2 includes money market mutual funds, repurchase agreements, and money market certificates, which have grown rapidly in response to high interest rates. Moreover, the short-run volatility of these aggregates seems to have been somewhat less over the first half of 1981 than in 1980, probably a reflection of the Federal Reserve's increased determination to hold to its targets. [3]

Monetary Aggregates Targets. The Federal Reserve has stressed that its money targets will not be eased to accommodate additional growth in GNP. In fact, Chairman Volcker testified in mid-July that the Federal Open Market Committee (FOMC) has adopted a somewhat lower range for M1B Adjusted in 1982. The target range for M2 is to be left unchanged. (The target ranges are shown in Table 9.) Although the change in the M1B Adjusted target is small, Chairman Volcker indicated that actual growth is expected to remain in the lower half of its range in 1981. He also stated that actual growth in M2 in 1982 would be close to the midpoint of its range, in contrast to the growth at the upper end of the range that has occurred in 1981.

Velocity, Interest Rates, and Credit Demands. Many analysts believe that the Federal Reserve's money aggregate targets are not consistent with strong economic growth in 1982. An argument that these targets may inhibit real growth can be derived from the long-run relationship between money and total spending in the economy, combined with strong inflation momentum. (The ratio of current-dollar GNP to a money target is referred to as the "velocity" of that target.) If the trend growth in the velocity of M1B Adjusted is about 3-1/2 percent, and if money is allowed to expand at a steady 5-1/2 percent rate (the upper end of the Federal Reserve's target range), this argument holds that, over a period of a few years, total spending will only be able to expand at a 9 percent pace (that is, 3-1/2 + 5-1/2). At the same time, if the underlying rate of inflation persists at, say, 8 percent, little room remains for real growth in the economy. Velocity growth may exceed 3-1/2 percent for a time; but, based on historical relationships, this would likely be accompanied by high short-term interest rates, which would eventually crowd out real growth.

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[3] The volatility in 1980 may have resulted partly from the imposition of credit controls in March.

TABLE 9. MONETARY AGGREGATES: TARGETS AND REALIZED GROWTH RATES (Percent change, fourth quarter to fourth quarter)

	Target Ranges	Actual
M1B Adjusted a/		
1980	4 to 6-1/2	6-3/4
1981	3-1/2 to 6	2-1/4 b/
1982	2-1/2 to 5-1/2	--
M2		
1980	6 to 9	9-1/2
1981	6 to 9	9-3/4 b/
1982	6 to 9	--

a/ M1B includes currency, demand deposits, and other checkable deposits at banks and thrift institutions. M1B Adjusted is lowered to account for shifts in deposits from time deposits (part of M2) to negotiable order of withdrawal (NOW) and automatic transfer services (ATS) accounts. It is estimated that these shifts added 1/2 to 3/4 percent to unadjusted M1B growth in 1980 and will add 2 to 3 percent in 1981.

b/ January to July 1981, at an annual rate.

From another vantage point, some forecasters expect high interest rates to persist in 1982, even without a strong pickup in economic activity, because of strong credit demands in some sectors. Heavy business borrowing for investment and individual borrowing for residential ownership are expected to limit any decline in interest rates. Compounding this situation, state and local and federal governments are also expected to be heavy borrowers.

CBO projects a unified budget deficit of about $65 billion in fiscal year 1982, but total borrowing from the public by the Treasury should significantly exceed the budget deficit (see Table 10). Off-budget borrowing, primarily to fund the Federal Financing Bank's loan activities, will add about $20 billion to Treasury borrowing in 1982. Total Treasury borrowing is, therefore, expected to reach $80 to $90 billion. The federal government's presence in the credit markets will also be felt as a result of $80 billion in new federal guarantees of private credit.

TABLE 10. FEDERAL BUDGET DEFICITS AND BORROWING FROM THE PUBLIC
(By fiscal year, in billions of dollars)

		Estimates	
	1980	1981	1982
Unified Budget Deficit	59.6	60	65
Off-Budget Deficit	14.2	24	20
Total Deficit	73.8	84	85
Means of Financing Other Than Borrowing from the Public a/	3.3	8.6	1.7
Borrowing from the Public	70.5	75.4	83.3
New Loan Guarantee Commitments b/	69.8	87	80

a/ Changes in cash balances, checks outstanding, and seigniorage on coins. Estimates from Mid-Session Review of the Budget, July 1981.

b/ Estimates from OMB, July 1981.

For a number of reasons, however, credit conditions may not be as limiting to economic growth as some forecasters expect. First of all, the Federal Reserve may not achieve its targets for money growth. Even if it does, financial conditions may not inhibit fairly strong growth in 1982:

- Monetary velocity has historically been quite unstable for periods as long as two years. High interest rates are often associated with rapid velocity growth. With record high interest rates providing a strong incentive to economize on money use, it would not be surprising if velocity growth also proceeded at record rates.

- Given the recent development of new financial instruments, such as six-month certificates and money market mutual funds, and with further changes expected as a result of recent legislation deregulating financial institutions, the relationship between money aggregates, interest rates, and GNP is changing. Many observers believe that a given level of money will now accommodate more growth in GNP than in the past.

- For business firms and individuals in high income-tax brackets, real after-tax interest rates may not have risen sufficiently to dampen their business activities severely. The impact varies greatly, however, depending on the tax situation. For business firms that have little or no profits, the real costs of borrowing are significantly higher.

- If inflation moderates quickly, as some forecasters expect, the Federal Reserve's monetary targets will be able to accommodate real growth more easily.

- The impact of high interest rates on business investment may be offset, at least in part, by recently enacted cuts in business taxes.

The CBO forecast for 1982 may be based on favorable assumptions about prices and about the velocity-interest rate issue. These assumptions are not, however, unreasonably optimistic. Nevertheless, the risks that economic growth will fall short of the CBO forecast are substantial.

CHAPTER IV. THE BUDGET OUTLOOK

This chapter discusses the budget outlook through 1984 using CBO's updated economic forecast and longer-range assumptions. It also examines the Administration's latest budget estimates presented in its Mid-Session Review of the 1982 budget. CBO's budget projections incorporate the changes in tax law resulting from the enactment of the 1981 Tax Act and the spending policies proposed by the Administration and included in the first budget resolution for 1982. They include the spending reductions enacted to date in the Reconciliation Act of 1981 as well as substantial further spending reductions assumed by the first budget resolution and the Administration's July budget estimates.

The CBO projections indicate that federal budget deficits will decline gradually over the next several years, but that budget balance will not be attained by 1984 unless the proposed growth of defense spending is curtailed, nondefense spending is scaled back even further, or increases in revenues are generated.

NEW BUDGETARY POLICIES

At the beginning of the year, the Administration proposed dramatic policy changes designed to slow inflation, encourage saving and investment, stimulate economic growth, and strengthen national defense. 1/ Toward these ends, the President proposed to reduce sharply the growth of federal spending over the next five years, cut personal taxes over the next three years, reduce business taxes through accelerated depreciation, and increase significantly the relative share of the budget allocated to national defense. The Administration also set a target of achieving a balanced budget by 1984. Its budget estimates were based on the assumption that real economic growth would average close to 4.5

1/ For a discussion of the Administration's budgetary proposals and economic assumptions, see Congressional Budget Office, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981).

percent annually over the 1982-1986 period, and that there would be a steady decline in inflation, unemployment, and interest rates.

In May, the Congress adopted nearly all of the Administration's budgetary proposals and most of its economic assumptions as part of its first budget resolution for 1982--the major exception was that the Congress assumed less rapid declines in interest rates. The first budget resolution specified sharp reductions in federal spending and revenues from their projected baseline levels. If realized, the resolution spending targets would hold the average growth in federal outlays during the next three years to less than 6 percent annually, or less than one-half of the average growth rate since 1976. Outlays as a percentage of GNP were projected to fall from over 23 percent in 1981 to 19.2 percent in 1984, the lowest level since 1966. The resolution also specified a change in spending priorities by increasing funds for national defense above projected baseline levels and reducing funds for nondefense programs. As a consequence, defense outlays would increase from about 24 percent of total budget outlays in 1981 to 32 percent in 1984.

The budget resolution specified large cuts in revenues that would reduce the average annual growth in tax receipts to less than 9 percent during 1982-1984, as compared with a projected growth rate of 14.5 percent under tax laws existing at the beginning of the year. Tax revenues were projected to fall from 21.1 percent of GNP in 1981 to 19.2 percent in 1984, a level that was last attained in 1977. As shown in Table 11, the first budget resolution also projected a rapid decline in the federal deficit and a small budget surplus by 1984. [2]

REVISED ADMINISTRATION BUDGET ESTIMATES

The Administration's Mid-Session Review of the 1982 budget reestimates revenue and spending for fiscal years 1981 to 1984. These new estimates, shown in Table 11, are based on revised

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[2] For a further discussion of the first budget resolution targets and projected baseline outlays and revenues, see Congressional Budget Office, Baseline Budget Projections: Fiscal Years 1982-1986 (July 1981).

TABLE 11. FEDERAL BUDGET ESTIMATES FOR FISCAL YEARS 1981-1984
(In billions of dollars)

Budget Aggregates	1981	1982	1983	1984
First Budget Resolution				
Revenues	603.3	657.8	713.2	774.8
Outlays	661.35	695.45	732.25	773.75
Surplus or deficit (-)	-58.05	-37.65	-19.05	1.05
Administration				
Revenues	605.6	662.4	705.8	759.0
Outlays	661.2	704.8	728.7	758.5
Surplus or deficit (-)	-55.6	-42.5	-22.9	0.5
CBO a/				
Revenues	605	653-658	693-703	740-755
Outlays	665	718-723	748-758	790-805
Deficit	60	60- 70	45- 65	35- 65

SOURCES: First Concurrent Resolution on the Budget for Fiscal Year 1982 (H. Con. Res. 115, approved May 21, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ Based on existing tax law as revised by the Economic Recovery Tax Act of 1981 and the spending policies specified by the first budget resolution.

economic assumptions, recent experience with the rate of spending for federal programs, completed Congressional action, and policy changes proposed by the Administration since March.

The Administration's earlier economic assumptions were revised to reflect actual experience during the first half of the year. The major changes included an expectation of somewhat higher real growth for 1981 (based on higher-than-expected growth in the first quarter), an improved outlook for inflation over the next several years, and higher interest rates for 1981 and 1982 (about matching the interest-rate assumptions used for the first budget resolution). The longer-run economic assumptions were changed very little. Table 12 compares the Administration's July economic assumptions with those used by the Congress for its first budget resolution for 1982.

The main budgetary implications of the Administration's revised economic assumptions, relative to its earlier budget estimates, are: lower automatic cost-of-living adjustments for indexed benefit programs, particularly in 1983 and subsequent years; and higher outlays for interest on the public debt and for programs that are sensitive to interest rates, in 1981-1983.

The Administration raised its estimated budget deficit for 1981 by less than $1 billion, to $55.6 billion, and lowered the projected 1982 deficit from $45.0 billion to $42.5 billion. For 1983, its projected budget deficit remains at $23 billion, and it continues to project a balanced budget for 1984. To achieve the 1983 and 1984 budget targets, however, the Administration postulates further spending cuts, of which about $30 billion in 1983 and $44 billion in 1984 are still unspecified.

CBO BUDGET PROJECTIONS

CBO's midyear economic forecast and its longer-run economic assumptions, summarized in Table 12, are very similar in basic pattern to those of the Administration and those assumed for the first budget resolution. CBO projects slightly lower economic growth in 1982-1984 than either the Administration or the first budget resolution. CBO also projects lower inflation in 1981-1982 than assumed for the resolution, but assumes a somewhat slower moderation of inflation in 1983 and 1984 than projected by the Administration and the resolution. The three sets of assumptions differ hardly at all with respect to the unemployment rate for the entire 1981-1984 period. CBO projects a slower decline in interest rates over the four years, the differences being especially large for 1982-1984.

The major budgetary implications of the CBO economic assumptions relative to the Administration's July estimates and the first budget resolution targets are: lower revenues, largely as a result of lower economic growth, and higher outlays for interest on the public debt and other interest-rate-sensitive programs. CBO also projects higher spending rates for defense and other programs

TABLE 12. A COMPARISON OF ECONOMIC ASSUMPTIONS (By calendar year)

Economic Variable	1981	1982	1983	1984
GNP (billions of current dollars)				
First budget resolution	2,941	3,323	3,734	4,135
Administration	2,951	3,296	3,700	4,097
CBO a/	2,931	3,255	3,624	4,018
Real GNP (percent change, year over year)				
First budget resolution	2.0	4.1	5.0	4.5
Administration	2.6	3.4	5.0	4.5
CBO a/	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator (percent change, year over year)				
First budget resolution	9.7	8.6	7.0	6.0
Administration	9.6	8.0	7.0	6.0
CBO a/	9.1	7.7	7.0	6.6
CPI (percent change, year over year) b/				
First budget resolution	11.1	8.3	6.2	5.5
Administration	9.9	7.0	5.7	5.2
CBO a/	10.1	7.2	7.0	6.2
Unemployment Rate (percent, annual average)				
First budget resolution	7.5	7.2	6.6	6.4
Administration	7.5	7.3	6.6	6.2
CBO	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate (percent, annual average)				
First budget resolution	13.5	10.5	9.4	8.2
Administration	13.6	10.5	7.5	6.8
CBO a/	14.5	12.4	11.4	10.1

SOURCES: Conference report on the First Concurrent Resolution on the Budget--Fiscal Year 1982 (to accompany H. Con. Res. 115, reported May 15, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ The Consumer Price Index used by the Administration is for wage earners and clerical workers in urban areas; the index used for the first budget resolution and CBO assumptions covers all urban dwellers.

than assumed by the Administration and the first resolution. As shown in Table 11, CBO projects that the 1981 budget deficit will be about $60 billion, almost the same level as for 1980 and only slightly higher than estimated for the first budget resolution. Subsequently, CBO's projections indicate that the budget deficit could rise to about $65 billion in 1982, falling gradually over the next two years to about $50 billion in 1984. Relative to GNP, however, the projected deficit would fall from nearly 2 percent of GNP in 1982 to about 1 percent in 1984.

Revenue Projections

The CBO revenue projections are based on current tax law as revised by the Tax Act of 1981, signed into law on August 13. The Tax Act provides for an unprecedented three successive annual reductions in personal income tax rates, with annual adjustments for the effects of inflation thereafter. It also provides for a large business tax cut, with scheduled step increases in the rates of depreciation in 1985 and 1986. The Tax Act will reduce projected fiscal year 1982 revenues by an estimated $38 billion, 1983 revenues by $93 billion, and 1984 revenues by $150 billion. Individual tax burdens will be decreased by $27 billion in 1982, and business taxes by $11 billion. Other measures that reduce projected revenues are essentially offset by revenue-raising provisions.

CBO's projections of current law revenues based on the CBO midyear economic forecast and longer-range assumptions are summarized by major source in Table 13. Total revenues are projected to rise from an estimated $605 billion in 1981 to about $750 billion in 1984, an average annual growth rate of about 7 percent--less than one-half the average growth rate since 1976. Relative to GNP, tax revenues are projected to decline from about 21 percent in 1981 to about 19 percent in 1984, virtually the same reduction as specified by the first budget resolution.

The CBO current law revenue projections are very close to the first resolution targets for 1981 and 1982, but are lower by about $15 billion for 1983 and $27 billion for 1984. The lower revenues for 1983 and 1984 are largely the result of lower projected personal income levels. The CBO revenue projections are also lower than the Administration's July estimates, by about $7 billion in 1982, $8 billion in 1983, and $11 billion in 1984. Again, the differences are largely attributable to less optimistic assumptions about income levels.

TABLE 13. CBO PROJECTIONS OF CURRENT LAW REVENUES BY SOURCE (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Individual Income Taxes	286	300	307	324
Corporate Income Taxes	62	67	79	85
Social Insurance Taxes	188	211	235	258
Excise Taxes and Other	69	77	77	82
Total	605	655	698	748

NOTE: The projections are midpoints of projected ranges.

Outlay Projections

The enactment of the Omnibus Budget Reconciliation Act of 1981 was a major step toward achieving the spending reductions specified by the first budget resolution. Implicit in the budget resolution targets, however, are additional savings--over and above those obtained in the Reconciliation Act--to be made through the appropriations process and by other legislative and administrative means. These additional savings amount to about $15 billion in 1982, about $35 billion in 1983 (of which $20 billion are unspecified), and about $50 billion in 1984 ($28 billion unspecified).

CBO's projections of outlays for 1982-1984 are based on the spending targets of the first budget resolution and assume that these additional spending reductions will be made. Total unified budget outlays are projected to rise from an estimated $665 billion in 1981 to between $718 and $723 billion in 1982 and to between $790 and $805 billion in 1984. This would represent an average growth rate of about 6 percent annually, close to the growth rate set by the first resolution targets. Relative to GNP, outlays would fall from over 23 percent in 1981 to about 20 percent in 1984.

The CBO outlay projections exceed the first resolution outlay targets by over $20 billion in 1982, and by similar amounts in 1983 and 1984. They are also higher than the Administration's July estimates--by a somewhat smaller amount in 1982, by over $20 billion in 1983, and by over $30 billion in 1984. CBO's outlay projections are higher for two major reasons: higher estimates of interest on the public debt and other interest-related costs, and higher estimates of defense outlays.

Interest rates used for the CBO projection of outlays for 1982-1984 are about two percentage points higher than the rates underlying the first resolution targets for each year. The differences between the CBO interest-rate assumptions and those used for the Administration's July estimates are even larger, as shown in Table 12. The higher CBO interest-rate assumptions add about $40 billion to the Administration's outlay estimates for the 1982-1984 period.

The higher CBO defense outlay projections represent technical estimating differences resulting from the use of different spending rate assumptions. CBO's projections assume that historical spending rates, especially for major procurement programs, will continue to apply to 1982-1984 outlays. CBO's defense outlay projections are about $5 billion higher than the Administration's for 1982 and over $6 billion higher for 1984, using CBO's spending rate assumptions and the mix of budget authority included in the Administration's July estimates. They are about the same amounts higher than the first resolution outlay targets for these years.

Other differences between the CBO outlay projections and the first resolution targets and Administration estimates result from somewhat different assumptions about the size of the annual cost-of-living adjustments for Social Security benefits and other indexed programs, and from technical reestimates for farm price supports, food stamps, medicare and medicaid, and assistance payments. These technical reestimates are based on recent events--such as the larger-than-expected corn crop--and spending trends.

Uncertainty of Budget Projections

Budget projections are very uncertain for several reasons. First, changes in economic conditions can have dramatic effects on the federal budget. If the economy does not grow as much as projected over the next several years, federal revenues will be lower than estimated and outlays higher. Budget outlays also have become increasingly sensitive to interest rates because of the growth in the federal debt. If interest rates, for example, are one percentage point higher than assumed by the CBO projections, interest-related costs would be increased by over $2 billion in 1982 and over $6 billion by 1984. Forecasting future economic conditions is subject to a great deal of uncertainty, and the longer the forecast period, the greater the range of uncertainty. 3/

A second element of uncertainty is that budget estimates can be off the mark for various programmatic and other technical reasons. Harvests can vary unexpectedly, natural disasters can occur, program spending patterns can change, and international events can lead to unanticipated changes in spending. The ranges shown in Table 11 for the CBO budget projections are intended to represent possible estimating errors arising from these factors. The ranges are less than 1 percent for projected revenues and outlays in 1982 and about 2 percent in 1984.

Third, the CBO outlay projections assume substantial additional spending reductions in 1982-1984 beyond those already enacted as part of the Omnibus Reconciliation Act. A large portion of these additional reductions are yet to be specified. Also, some of those that have been identified, such as the Administration's Social Security proposals, may be substantially modified. If the Congress does not approve the Administration's proposals for further program reductions, and if the federal agencies are unable to achieve the administrative savings assumed for the budget projections, budget outlays and the federal deficits could be much higher than estimated.

Conclusion

The differences in economic assumptions used for the first budget resolution, the Administration's Mid-Session Review of the budget, and the CBO budget projections are not very great. Neither are the differences in revenue and spending estimates, considering the uncertainties involved. Nevertheless, these differences do affect the outlook for a balanced budget by 1984. The CBO budget projections imply that the federal budget is likely to remain in deficit in 1984 unless the projected growth in defense spending is scaled back, nondefense programs are cut further, and/or additional revenues are generated.

3/ For a further discussion of the sensitivity of budget estimates to economic assumptions, see Congressional Budget Office, Baseline Budget Projections: Fiscal Years 1982-1986.

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